S. Hrg. 99-556

INTERGOVERNMENTAL EFFECTS OF TAX REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 3, 1985
ST. PAUL, MN

Printed for the use of the Committee on Governmental Affairs

58-565 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1986

S401-24

COMMITTEE ON GOVERNMENTAL AFFAIRS

WILLIAM V. ROTH, Jr., Delaware, *Chairman*

TED STEVENS, Alaska	THOMAS F. EAGLETON, Missouri
CHARLES McC. MATHIAS, Jr., Maryland	LAWTON CHILES, Florida
WILLIAM S. COHEN, Maine	SAM NUNN, Georgia
DAVE DURENBERGER, Minnesota	JOHN GLENN, Ohio
WARREN B. RUDMAN, New Hampshire	CARL LEVIN, Michigan
THAD COCHRAN, Mississippi	ALBERT GORE, Jr., Tennessee

John M. Duncan, *Staff Director*
Margaret P. Crenshaw, *Minority Staff Director*

Subcommittee on Intergovernmental Relations

DAVE DURENBERGER, Minnesota, *Chairman*

TED STEVENS, Alaska	LAWTON CHILES, Florida
THAD COCHRAN, Mississippi	SAM NUNN, Georgia

Margaret Wrightson, *Staff Director*
Robert F. Harris, *Minority Staff Director*
Jodi Mathison, *Chief Clerk*

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

CONTENTS

Page
Opening statement of Senator Durenberger 1

WITNESSES

Wednesday, July 3, 1986

Paul A. Anton, director of economics, First Bank, Minneapolis, MN; and Alan K. Ruvelson, president, First Midwest Corp., representing Minnesota Association of Commerce and Industry 4
Roger D. Moe, majority leader, Minnesota State Senate; Bill Schreiber, Minnesota House of Representatives; George Latimer, mayor, St. Paul, MN; Jean Olson, president, Minnesota School Boards Association; and Jay Kiedrowski, commissioner, Minnesota Department of Finance 17
Rollie Lake, president, Communicating for Agriculture, Fergus Falls, MN; Gordon Donhowe, executive vice president, Fairview Community Hospitals; Archie D. Chelseth, manager, public affairs, Potlatch Corp., Al E. France, president, Lake Superior Industrial Bureau; and John G. Horner, general counsel, Minnesota Multi-Housing Council 61
Catherine E. Holtzclaw, partner, Bane, Holtzclaw & Associates; Walter McClure, president, Center for Policy Studies; Peter Rode, research director, Minneapolis Urban Coalition; and Jim Solem, executive director, Minnesota Housing Finance Agency 99

Alphabetical List of Witnesses

Anton, Paul A.:
  Testimony 4
  Prepared statement 10
Chelseth, Archie D.:
  Testimony 61
  Prepared statement 83
Donhowe, Gordon:
  Testimony 61
  Prepared statement 79
France, Al E.:
  Testimony 61
  Prepared statement 90
Holtzclaw, Catherine E.:
  Testimony 99
  Prepared statement 107
Horner, John G.:
  Testimony 61
  Prepared statement 90
Kiedrowski, Jay:
  Testimony 17
  Prepared statement 55
Lake, Rollie:
  Testimony 61
  Prepared statement 74
Latimer, George:
  Testimony 17
  Prepared statement 38

Page
McClure, Walter:
  Testimony 99
  Prepared statement 109
Moe, Roger D.:
  Testimony 17
  Prepared statement 29
Olson, Jean:
  Testimony 17
  Prepared statement 52
Rode, Peter:
  Testimony 99
  Prepared statement (for Peter Belton) 115
Ruvelson, Alan K.:
  Testimony 4
  Prepared statement (for Minnesota Association for Commerce and Industry) 14
Schreiber, Bill:
  Testimony 17
  Prepared statement 33
Solem, Jim:
  Testimony 99
  Prepared statement 123

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

"Life Insurance and the Administration's Tax Reform Proposal", by Dean A. Wahlberg, vice president, corporate affairs, the Minnesota Mutual Life Insurance Co., dated July 3, 1985 129
Comments to Senator Durenberger on the Reagan Tax Plan from the Minnesota Association of Realtors 133
Testimony of Tom Newcome, legislative liaison, Minnesota Restaurant, Hotel, and Resort Associations 134

INTERGOVERNMENTAL EFFECTS OF TAX REFORM

WEDNESDAY, JULY 3, 1985

U.S. SENATE,
SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
St. Paul, MN.

The subcommittee met at 9:30 a.m., in room 15, State capitol, Hon. Dave Durenberger (chairman of the subcommittee) presiding.

Present: Senator Durenberger.

Senator DURENBERGER. The hearing will come to order.

OPENING STATEMENT OF SENATOR DURENBERGER

Senator DURENBERGER. The subject of today's hearing is the effect of President Reagan's tax reform plan on Minnesota and Minnesotans. I'm especially glad to be here in St. Paul to talk about the plan because, thus far, a lot of the discussion in Washington has been about averages: the average taxpayer, the average family, the average business.

In truth, we know in this State that there is no such average person, average family, or average enterprise. It's only when we break out the impacts of the plan that we will understand its full effects.

We must measure the President's plan, and all the other tax reform proposals, according to what they will mean for our different regions, for different kinds of industries, for different kinds of families—two-earner families as well as so-called traditional families—and, finally, for different kinds of taxpayers. A good place to start looking for these answers is right here. This is where the changes will be felt.

Before we start today, I want to share with you some concerns I have about tax reform and the President's approach to it.

What's wrong with the existing Tax Code is clear to most Americans. Eighty percent think that if they play by its rules, they can't get ahead. Most Americans think the code gives breaks to everyone but them. And I know how they feel. This year, George Bush had a higher income than I did, as usual; but I was in the 44-percent tax bracket, and he was in the 12½-percent bracket.

Today, the Federal Tax Code is over 3,000 pages long, and it takes a small library to house the Federal regulations that are used to interpret it. You and I know that something that complex is doing a lot more than raising revenue. It's also spending money. Every time we write a law or rule which gives a credit, an exemption, or a deduction, we're spending dollars we otherwise would have collected. These tax expenditures add up to big dollars, $367 billion in fiscal year 1985.

By any definition, reform means improvement. When we reform something, we ought to be better off when we're through than we were when we started. So, if we really mean to reform the Federal tax system, and not just to change it, then the result should be a Tax Code that's fairer, simpler, more efficient, and supportive of economic growth. If the reforms we enact don't accomplish these things, then the system isn't better; it is only different.

The President says his plan will do all these things; and if that's true, I will vote for it. The question today is, will it?

It would have to promote fairness in tax burdens so that those of equal incomes would be treated equally; it would not allow those who can shelter their income to avoid paying their fair share.

It would have to simplify things so that it won't take an army of accountants to figure out what's in the code.

It should not favor one kind of family over another.

It should not penalize a taxpayer just for living in a high-tax State.

It should place greater emphasis on taxing consumption than on work.

And it ought to support economic growth for all types of commerce and industry, not just a favored few.

Just 4 years ago, Congress enacted a sweeping tax reduction and reform bill that was supposed to accomplish many of these goals. We cut the top marginal rate from 70 percent to 50 percent. We reduced all rates by 25 percent. We adopted an accelerated depreciation system, and expanded IRA's and 401(K) plans. Now, we're at it once again.

I endorse the same principles for reform that the President does. Bring down the rates. Lift the burdens on those of especially low income. Broaden the base. Don't use tax reform as a Trojan horse for a massive tax increase.

But I'm troubled, because when I read some of the fine print I know that it won't accomplish all that the President says it will. What's more, there are other things we ought to be doing which are not contained in this plan.

Tax reform ought to be part of a larger effort to design a fiscal policy which balances consumption against the need for saving and investment. The continued allowance of deductions for interest payments other than mortgages continues to bias our system toward consumption and away from savings. We must safeguard the ability of State and local governments to raise the revenues they must, to deliver the most basic public services to the communities where we live, raise our families, and educate our children.

And, finally, we must design a tax system that fits the reality of today's growing economic competition.

I am afraid that, in these respects, the President's tax plan may come up short. Today, we will hear from some of you who are in a position to know.

In our first panel today, we will hear from Mr. Paul Anton, director of economics at the First National Bank of Minneapolis; and Mr. Alan "Bud" Ruvelson, who's president of First Midwest Corp.

Bud is also former chairman of the Minnesota Association of Commerce and Industry and will be here today speaking on behalf of MACI. We welcome you, gentlemen.

As everyone knows, our statements today are limited to 5 minutes. Your full statements will be made part of the hearing record and may be elaborated on in writing at any time.

[Prepared statement of Senator Durenberger follows:]

PREPARED STATEMENT OF SENATOR DURENBERGER

If the measure of fairness in tax reform is that counties are better off after reform than prior to reform, the President's proposal on tax reform, specifically the elimination of State and local deductability, fails this fairness test dramatically.

Counties in Minnesota do recognize the need and desire for tax reform. It is a policy that counties support at both the State and Federal levels. Counties in Minnesota traditionally have supported direct accountability for their fiscal decisions. It is simply not appropriate, nor in the best long-term interests of good government, to allow one governmental body to make decisions that become the fiscal liability of another. Minnesota counties are in a constant battle with regard to that basic issue.

The reality of where the tax system is relative to good policy is a dichotomy. A simply-stated tax philosophy of equity, fairness and self-reliance overlooks the complexity of tax, revenue and expenditure inter-relations for county government. It overlooks the dependence counties have on the system to meet all of the service and program needs they are expected to provide. A radical departure in the name of reform will have dramatic consequences on the revenue capacity of Minnesota counties.

Minnesota counties levied from the property tax in 1985 approximately $735 million of gross taxes to provide services to their citizens. In most cases over 50 percent of that gross tax levy is used to provide services that are the policy and priority (mandates) of State and Federal Government.

If the studies by the ACIR and other studies relative to the impact of eliminating State/local deductability are reasonably accurate in measuring the elasticity impacts on future fiscal decisions, then the gross impact on Minnesota counties prior to the proposed tax rate changes is in a range of $59 million (ACIR) to $154 million (Noto & Zimmerman) annually. It is our understanding that if the income tax rate changes occur as proposed then those impact numbers may be $47 million to $123 million, respectively, in either case a potentially significant impact on Minnesota counties, especially when coupled with a $50 million loss in GRS and potential reductions in community service block grants, social services, food stamps, job training, medical assistance, economic development and public works to name several areas.

Specifically counties in Minnesota would like to make the following points:

(1) Over 50 percent of nearly all Minnesota county budgets are committed to the provision of human services. Much of that program and service effort is directed by Federal policy. Accountability at the local level is an administrative shell. Is it fair or equitable to suggest that the Federal Government may continue to mandate policy while shifting more costs to State and local taxpayers in the name of accountability and self-reliance?

(2) Counties in Minnesota are under court orders to provide adequate detention and lock-up facilities. Passing Referendum bond issues is the most reasonable means of meeting funding needs even though it is now very difficult to pass unpopular jail bond issues. Elimination of State and local deductability will increase these difficulties and reduce the capacity to provide adequate law enforcement and incarceration.

(3) The impact of reducing revenue capacity for Minnesota counties will cause a shift within each county of funding priorities from those programs and services of a discretionary nature (arguably the most desirable services) to those services and programs that represent someone else's priorities. That shift does nothing to enhance local accountability or provide a feeling of self-reliance.

(4) Outmigration is one of the potential impacts. For many Minnesota counties that are experiencing either agricultural- or mining-caused economic stress the issue of elimination of State/local deductability becomes another factor that may speed up the decline. Those counties (estimated to be 67 of the 87 by Minnesota DEED) are experiencing and will experience greater spending for human services as the real tax base narrows. Both potential expenditure increases and tax base pressure affects outmigration and inmigration.

(5) The further Catch-22 is that economic incentive packages to encourage growth or development in distressed areas become less desirable if they are tax-based incentives.

It would suffice to say that the phenomenon of change, if carried out as proposed, will create significant problems for Minnesota counties.

From a policy perspective Minnesota counties encourage the consideration of the following five points:

(1) The Federal taxing system must recognize that some local taxing decisions are inextricably linked to Federal decisions and that cost ought not be further shifted to the local level.

(2) That the implicit subsidy that results from deductability ought not be singled out and eliminated without understanding its relationship to total revenues generated by a State relative to the total direct and indirect (or implicit) subsidies received.

(3) That implicit subsidies cannot or should not be eliminated until they are reconciled with Federal program policy and direct subsidies that support that policy.

(4) That State and local taxes above a base level remain deductible or at a minimum a phased approach be studied. Continued cutbacks on the expenditure side (GRS) coupled with the elimination of State/local deductability decreases the ability to respond.

(5) That in establishing the overall tax rates and treatment of individual groups the reformers need to ensure that the tax rate policy does not further work against individuals either struggling to move off or struggling to stay off of the welfare system. This is particularly true of the poor, the single parent and child care provisions.

In conclusion, Minnesota counties have a keen sense of the need for tax reform and revenue restraint. Minnesota counties are also aware that tax reform is primarily aimed at people (taxpayers) and that the utilization of those revenues by State and local governments is a secondary consideration. However, when the Federal and State governments effect tax reform and expenditure modification, restraint or reduction, it places dramatic pressure on local governments to follow suit. Yet, the actions of the State and Federal governments do little to reduce expectations for service and in fact often enhance it by shifting responsibility or failing to reduce the responsibility at the appropriate level. Consequently, the continuing tax reform phenomenon or the swinging pendulum shifts to the local level.

Minnesota counties implore you to give consideration to the resource capacity and utilization of tax resources at the local level. And to understand the ability to adjust is not solely ours.

On behalf of Minnesota counties, thank you for your time and consideration.

Senator DURENBERGER. Mr. Anton, you may begin.

TESTIMONY OF PAUL A. ANTON, DIRECTOR OF ECONOMICS, FIRST BANK, MINNEAPOLIS, MN; AND ALAN K. RUVELSON, PRESIDENT, FIRST MIDWEST CORP., REPRESENTING THE MINNESOTA ASSOCIATION OF COMMERCE AND INDUSTRY

Mr. ANTON. Is there a timekeeper around? OK.

I'm pleased to be here. It seems to me that most economists would be equally at a loss to try to contain any set of thoughts in 5 minutes or try to come up with little enough biographical material to fill only 60 seconds of introduction. I will try to do both.

I think that talk about the humility of professional economists or perhaps the lack thereof is appropriate because the tax documents from the Treasury are a monument to the overconfidence of economists who think that they are saying something more exact or more profound if they put decimal points on their forecasts.

I would like to speak mainly about the growth aspects of the President's tax proposal. I would, however, like to make one comment about simplicity. Economists define simplicity in terms of the amount of economic resources that are used up in operating the tax system, both by filers and by tax collectors. On this basis, I think it extremely unlikely that there is any substantial simplification in the tax laws we are talking about. I have mentioned why in my statement.

Now to the growth aspects of this provision and the macroeconomic aspects that I have some expertise to address.

The first thing I would say is that the revenue neutrality of this provision should not be considered seriously and Congress should take no pains to preserve that neutrality in its deliberations.

First of all, that neutrality is based upon an economic forecast which I'm sure you know is a pretty optimistic one relative to what professional economists as a group would endorse.

Second, attempting to preserve this neutrality just adds an artificial constraint to the structure of the tax system we are talking about.

In particular, every study of the tax system of an industrialized economy recommends making the top marginal tax rate for individuals and the corporate tax rate equal in order to avoid generating dummy corporations simply to avoid taxes. Yet here those rates are a couple percent different—only to preserve some kind of artificial neutrality.

The third point I would like to make is that this proposal cannot be analyzed in a vacuum. To do so would be to perform what we economists call partial equilibrium analysis. In partial equilibrium analysis, you look at what happens in one market but don't look at what happens in other markets and other parts of the economy which may react to the change you analyze. Passage of the proposal we are talking about would set in motion chains of events, many in the political process, that would certainly affect the economy and further alter the tax system as a whole.

The elimination of tax spending for a variety of items would undoubtedly intensify pressure for explicit direct spending on those same items. In fact, that's mentioned explicitly in the report where it states that the effect of the repeal of these provisions is assumed to be offset by increased expenditures—for a specific item. I wonder why we are taking the trouble to change the law, in that case.

Second of all, the adverse impact of getting rid of the investment tax credit for certain import-competing industries will just intensify pressure for certain kinds of protectionism that would be detrimental to our overall international competitiveness and to the long-term vitality of our industries.

And finally, and I suspect something this is going to get a lot more comment here today, the interplay of the taxing and spending of other levels of government must be examined closely. If we take revenues from State and local governments and give them to the Federal there is going to be a reaction to raise revenues or cut services, probably raise revenues at the local level.

The overall tax system that the individual will face may not be nearly as fair as claimed currently.

And finally, the last comment I would like to make is that economists inside and outside of the Government are extremely concerned by the mix of fiscal and monetary policy we have right now and point to the deficit as the chief problem facing us currently.

I think that this proposal taken as a whole, would swell the deficit. The odds are at least 80 to 20 that it would increase deficits in the future, in my view. If I had to say yes or no to the whole thing, I would say no on the basis it would make the bigger problem that we need to face, that of generating economic growth by solving the deficit question, much harder to deal with.

Senator DURENBERGER. Paul, thanks. When Bud gets through then maybe both of you can come up if I have a question for you. Alan Bud Ruvelson?

Mr. RUVELSON. Obviously my mother didn't expect me to go out for basketball.

I speak to you as a businessman for 49 years in our State and I am speaking for and on behalf of the Minnesota Association of Commerce and Industry [MACI], which is in its 77th year and includes 5,200 companies and 100 community chamber of commerces and 100 trade and professional associations in its membership. Obviously we don't speak for them as it's a large association representing a diversity of interests.

While we have not generally become directly involved in issues relating to the National Government, we have surveyed a representative sample of our membership for their reactions to President Reagan's tax reform proposal. We have received a first response to a lengthy questionnaire mailed to a representative sample of our membership.

We are proud to be able to say that the majority favor tax reform beneficial to the greater society even though the immediate effect on them or their own particular business might be a negative one.

There has been a reaction to the proposed flat or modified tax rate and there is a slight majority in favor of a flat tax rate to the present system, about 54 to 46 percent.

The modified flat tax for individuals with the three rates as more recently proposed, 15, 25, and 35 percent is preferred to the present system by an even larger margin, 59 to 41 percent.

So far as the underground economy and what we can do about it, there are some suggestions that we have been given by our members but I will not take your time.

On the depreciation rate recognition, 80 percent were opposed to the proposed changes in the ACRS while only 15 percent favored.

As to the effect on their firm, which they are responding for, 58 percent concluded that the proposal if enacted as proposed would negatively affect their particular firms and only 11 percent thought their firms would be favorably affected.

However, and this is the important part, 58 percent, not necessarily the same respondents, thought that the proposal was fair to their firm as compared to other firms. In other words, members in their sampling are taking a broad overview.

As far as the effect on industry, 57 percent perceived the proposal as unfavorable to their particular industry and 71 percent, which is a relatively large percentage, perceived the proposal as harmful to the Midwest, while only 3 percent thought the proposal as drafted favored the region.

However, the proposal was perceived as fair to the Midwest by 49 percent to 33 percent.

In other words, compared to the alternatives as posed by the present system and what else we have to look forward to, I think that means that there has been a rather generous appraisal.

So far as raising capital, respondents were asked to disclose their anticipated sources of capital and we concluded from their responses that there would be an effect on the profitability and the ability to generate funds for investments because 37 percent felt that the proposal would not affect the way they could raise capital. Thirty-seven percent were unsure and 26 percent felt that the proposal would result in a decrease in investment.

Within MACI we have a small business council which is a segment of the broader organization. That group concluded that the certainty and predictability of tax laws are especially important for smaller enterprises. Therefore, whatever reform measures are adopted should include appropriate dates of transition and effective delays so that you can have an orderly transition.

Abrupt tax changes can and do bring about confusion and uncertainty.

We have concluded that the seemingly paradoxical responses indicate that our business constituents want tax reform. That's the bottom line, and we encourage you to press on with efforts to make the proposal even more economic and administratively efficient. In addition membership response indicates that we support your efforts to amend the Tax Code to provide a growth environment for capital formation, human and physical capital, and the creation of quality jobs.

Senator **Durenberger**. Bud, why don't you stay up there. Paul, would you join him up there? I have a couple of questions maybe both of you can answer.

Paul, in your testimony you estimated that deficits are more important than tax reform right now, if we have to make some choices. You also indicated some concerns—and I think the Congressional Budget Office the other day did also—that passage of this bill might decrease revenue by as much as $35 billion over current law, between 1986 and 1990.

Let me ask both of you: Are we faced with a situation where we have to make choices between tax reform and deficit reduction? And if the answer to that is no, if it isn't an either/or proposition, then is the driving force behind tax reform in this country to get the rates down? Or is it to do something else? What is the part about the President's bill that is most appealing? And should we start with you, Paul, since you were the first.

Mr. **Anton**. Well, it seems to me from a macroeconomic point of view there is no question the deficit is a lot more of concern with regard to economic growth and the health of the economy overall. And every study that I have seen tends to indicate that the people at the Treasury are on the lunatic fringe in terms of overestimating the benefits of lowering marginal tax rates.

Senator **Durenberger**. I think they have been told.

Mr. **Anton**. I feel that what we are talking about would undo a lot of what's been done earlier this year in terms of deficits. It's a political question, whether or not there is enough political energy to do what is necessary to clean up the things in this proposal that I would call "revenue trivial," although they're obviously important from a fairness point of view.

If there is enough energy left to do more on the deficit, I guess it would be fine to do these things.

Mr. Ruvelson. I would take somewhat of a different viewpoint. I do not have the academic credentials of Mr. Anton, I have a BBA from the University of Minnesota School of Management, but a graduate degree from knocks, "hard knocks," and I believe we can do both.

I also have somewhat of a political background and I think we have got to keep the pressure on both aspects as they are both important. I would be first to subscribe to the importance of balancing the budget and I'm going to say I would like to be able to take this administration at its word and be sure whatever you do and the President proposes is at least revenue neutral. As far as I'm concerned it could even be more so. Their assumptions may not be correct but the thought is there.

I can say that if we are ever going to have tax reform I think now is the time—the way to resume is to do it now and I think we have got to keep the heat on both goals. That's what I support.

Senator Durenberger. Could either of you explain to me exactly what lowering the marginal rate substantially below 50 percent has to do with capital formation? How it relates to growth, to increased capital investments, and so forth? We were told in 1981 the same thing they were told in the 1960's: If you just get the marginal rate down below 93 percent, then you can get rid of tax shelters. In 1981, we were told: If you can just get it down to 50 percent, then we won't use tax shelters. Now, we are being told that we have to get it down substantially below that for people to go risk with their investments rather than make tax-motivated investments.

Mr. Ruvelson. I would be derelict in my duty as a venture capitalist if I didn't say I support the President's proposal so far as capital gain rates of 17½ percent.

I believe that it's necessary to have effective recognition of the qualitative difference of venture capital gain versus ordinary income in the capital formation process. But, I would believe that a proper rate structure would be also productive so far as encouraging savings for the enhancement of capital growth.

Mr. Anton. I think we have enough information about what will happen to the tax shelter industry to make a forecast extrapolating off of the experience you just mentioned. I don't think there is going to be a bit of difference in the amount of sheltering activity as a result of this proposal. All it does is to change the break-even point a little bit in terms of how many resources can be put into those things. But, I wouldn't expect a major change in that regard.

Senator Durenberger. The other part of that question was: If 50 percent wasn't the point at which everybody would save and invest without some other supporting mechanism of the code, is there a point? Is it 45, 40, 35, 30, 25, 20?

We keep asking these questions in Washington and don't get any answer.

Mr. Anton. Economists have no magic answer on that. There is obviously a continuum and you are better off with the lower rate than higher in terms of different kinds of capital formation.

But, those estimates are very slippery and I would just take them with a grain of salt. That's all I can say.

Mr. RUVELSON. I would agree there is no magic number. However, I think whether it's in Communist China or any other area of the world when you give the population an opportunity to keep the greater percentage of the results of their labor I think you can see what an incentive does and I think it's productive for the capital formation program.

Senator DURENBERGER. Do you agree, Bud, with Paul that the elimination of the investment tax credit is a dangerous thing to undertake in light of the economic competition from other countries?

Mr. RUVELSON. Well, like anything else they are talking about, I will say that as regards the investment tax credit, any precipitous change can bring some very unfortunate results. Witness our own company's situation when in the so-called Deficit Reduction Act of 1984 they not only prevented us from doing a passthrough of appreciated securities as a return to capital, but visited us with a double whammy of treating it as corporate capital gain and then as ordinary income. What has happened, as you know, is that we have announced that we are liquidating because it appears impossible to continue on an economic basis. I think any change can be lived with provided effective dates are so arranged and they can be phased in. But, anything that's a quick fix is going to be very much a disaster.

Mr. ANTON. There's well established economic literature on the welfare loss from changing the rules of the game for economic agents in midstream. It seems to me the way to minimize the resources expended in the tax system would be to minimize the amount of change there is in that system so that there cannot be annual big seminars on the revisions to the Tax Code. The burden of tax change falls most heavily on the small businesses who do not have huge planning staffs and computerized models to manage their tax positions.

Mr. RUVELSON. You said it much better than I, but that's my opinion.

Senator DURENBERGER. We get rid of the tax shelters, we get rid of the seminars and the cruise ships they are held on.

[Prepared statements of Messrs. Anton and Ruvelson (representing the Minnesota Association of Commerce and Industry) follow:]

Prepared Statement of Paul A. Anton

MR. CHAIRMAN:

I am pleased to speak today as a private citizen and as a professional economist on the President's Tax Proposal for Fairness, Simplicity, and Growth. I have a few remarks to make with regard to fairness and simplicity, but my main focus will be on the economic growth aspects of the proposal since my expertise is in that field. (This view implies that the fairness and simplicity aspects should be addressed by a moralist and a logician).

Fairness

In a certain sense, the tax proposal does increase the fairness of the tax system in that it eliminates a number of special benefits to small taxpayer groups.

In the individual income tax, the tax preference targeted explicitly seem to satisfy commonly held standards of fairness. For example, the elimination of the deduction for cruise ship seminars seems justified - except, of course, for those operated or attended by economists. However, the guts of the change in the individual income tax is to reduce the net progressivity of the tax system. On this basis, I must express the personal judgment that the tax proposal does not promote greater fairness, taken as a whole. This comes as no surprise since the dialogue concerning a flat tax centers on the trade-off between lowered progressivity and greater incentives to growth - a subject to which I will return later. Nevertheless, unless one adopts the definition that a proportional tax is fair, the fairness of the system is reduced by the major changes to individual taxes.

In assessing the fairness implications of the corporate tax changes, I confess to a lack of strong first principles on which to draw. Other than the principle that similar entities be taxed similarly, I have no precept to help me assess this issue. It is undoubtedly true the proposed change eliminates certain narrow tax preferences - but I admit to the suspicion that those very same preferences were probably passed in many cases, on the basis of some fairness argument which is simply not being listened to currently.

On the other hand, it is clear that the major provisions of the change in corporate taxes impact corporations asymmetrically. By lowering corporate tax rates and repealing the investment tax credit, the proposal definitely shows a relative benefit to corporations which have minimal needs for physical capital. This is by most definitions, unfair but I suppose it could be argued that the change "undoes" an inequality in the existing structure. This issue seems, to me, to be quite unimportant relative to growth aspects of the effect of corporate tax changes.

Simplicity

The simplicity issue is addressed by economists by analyzing whether or not the proposed changes will have the effect that fewer economic resources will be used in the operation of the tax system - resources either of the tax filers or the tax collectors. On this basis, I think it extremely unlikely that the tax system is simplified by the proposed change. With regard to the most visible supposed "simplification" the replacement of 14 brackets with three in the individual tax, I see no resource saving whatsoever. I think most people read their taxes from a table of AGI and taxes payable and whether the formula used to generate the table is simple or complex does not affect the time or calories I expend in running my finger down the table.

More generally, I do not believe that amount of man hours inside or outside of government which are used to figure and collect our taxes will be affected in any noticeable way. I infer that if simplicity were really an important concern, it would be politically much more popular to propose a proportional tax with no deductions than it is today.

Growth

It appears to me that the real animus for this tax reform is the belief that our current tax system inhibits the health and vitality of our economy and I would argue that the only issue which really is worth society's time to consider is whether we can change the tax code in a way that promotes economic growth. I would like to make several points to clarify what I think should and should not be the relevent issues in considering this proposal.

1. The revenue neutrality of proposal should not even be considered and Congress should take no pains to try to preserve that neutrality. For one thing, the revenue neutrality is specific only to a single assumed future path for the economy and, as such, is particularly chimerical. It is not possible for us to know enough about the future state of the economy to place any faith in a particular scenario or a statement of balance. Legislators need to keep in mind that they are dealing with decision which (like any fiscal policy decision) affect future deficits and should try to estimate those effects, however imperfectly. Secondly, attempting to preserve some measure of neutrality merely adds an artificial constraint to the tax system which works directly against some of the hoped-for fairness and simplicity goals of the legislation. For example, every respectable scholarly study of the tax system of a modern country recommends that the highest marginal individual tax rate and the highest marginal corporate tax rate be equated to eliminate the incentive to produce non-productive corporations merely to minimize individual tax. Conversations with Treasury officials make me pretty sure that the inequality of these rates in the President's proposal is dictated by the need to defend the package as "revenue neutral".

2. The proposal should not be considered in a vacuum. In particular, the proposal, I think, sets in motion chains of events (many of them in the political process) which have economic implications which need to be considered in assessing

the economic impact of the package.

First, the elimination of "tax-spending" for certain items may intensify the pressure for explicit direct spending on those same items. Such a prospect is recognized in the document itself. I find instances (in the footnotes) where the elimination of a particular worthwhile deduction is accompanied by a note that says "the effect of the repeal of these provisions is assumed to be offset by increased expenditures".

Second, the adverse impact on certain import-competing industries in the U.S. may intensify pressure for trade protections which would be detrimental to the development of the U.S. economy. I am thinking, generally, of manufacturing firms who will find it harder to re-tool and upgrade production facilities without preferences for corporate investment.

Finally, the interplay with the taxing and spending decisions of other levels of government must be examined closely. The most obvious provision which is likely to generate response from other governmental units is, of course, the repeal of the deductibility of state and local taxes. In particular, local units of government will either have to cut services or raise revenues to offset the revenue impact on them. A less obvious effect will be the increased cost of servicing tax-exempt debt in a world of lower marginal taxes and decreased attractiveness of municipal securities to institutional investors.

3. Consideration of this proposal needs to be focused on two big macroeconomic issues that confront us as a society: solving the deficit problem to achieve a more reliable mixture of monetary and fiscal policy and encouraging capital-formation to enhance the competitiveness of U.S. industry.

We continue to operate the U.S. economy by maintaining a delicate and fragile balance between expansionary fiscal policy and monetary restraint. The only respectable intellectual position is that such a policy configuration exposes us to economic risks with which our policy institutions were not designed to cope. The contrast between those domestic industries which prosper in this tenuously - maintained expansion and those which flounder because of either high interest rates or a strong dollar is, I believe, unparalleled in U.S. history. The longer-term viability of our economy is seriously threatened by this asymmetry.

The health of our financial system is also imperiled by this unusual policy mix. The unpredictability of capital flows, the financial strain of absorbing large amounts of Federal debt and the increased loan default risk in substantial sectors of the U.S. economy all make the current period a hazardous one for the health of individual financial institutions and of the financial system itself.

The longer-term growth of the U.S. economy can be assured most easily by addressing the Federal deficit issue now, while the economy continues to grow. In voting on all or part of this reform package, legislators are having a very definite budget impact whether they (or the President) chose to look at it.

A second, very troubling, implication of the tax proposal is that it would roll back or withdraw investment incentives at a time when those incentives hold great promise or hope for the American economy. We need to upgrade our productive capacity through capital replacement and deepening if we are to meet international competition. We also need to delineate a new pattern of U.S. participation in world commerce and the intensive development of new "niches" is likely to be capital intensive. It is important to retain the hard-fought incentives for productive corporate investment extant in the tax code.

To be sure, the lowering of the personal marginal tax rates creates some incentives to growth. Countless studies have estimated those incentives as being a lot more modest than the discourse of supply-side economists seems to imply. Taken as a whole, the proposal does not generate strong incentives for growth.

In my view, the President's proposal contains two sets of provisions: small, "loop-hole" closings which I shall dub "revenue trival" and fundamental shifts of the individual and corporate tax framework which have important revenue and economic impacts. It would be tragic if we were to waste a lot of political and social energy on the former without devoting enough resources to the critical economic choices which face us as a society.

STATEMENT* OF THE
MINNESOTA ASSOCIATION OF COMMERCE AND INDUSTRY
BEFORE THE
FIELD HEARING OF
U.S. SENATOR DAVID DURENBERGER

The Minnesota Association of Commerce and Industry (MACI) is the Minnesota State Chamber of Commerce and the Minnesota Manufacturer's Association. In our 77th year as a voluntary membership organization, our membership has grown to 5,200 individual companies, 100 community chambers of commerce and 100 trade and professional associations.

The association has focused its energies on developing a more prosperous Minnesota and enhancing development opportunities for individuals throughout the state by improving the efficiency and accountability of state and local government in Minnesota. While we do not generally become directly involved in issues relating to the national government, we have surveyed a representative sample of our membership on their reactions to President Reagan's Tax Reform Proposals.

We received the first responses to a lengthy questionnaire mailed to a representative sample of our membership. We're proud to be able to say that the majority favor tax reform beneficial to the greater society even though the immediate effect on them or their business might be negative.

Flat Tax and Modified Flat Tax

- A single rate flat tax for individuals is preferred to the present system - 54% to 46%.
- The modified flat tax for individuals with 3 rates of 15, 25 and 35% is preferred to the present system by an even larger margin - 59% to 41%.

---

* Presented by MACI Board of Directors member Alan K. Ruvelson, Chairman, First Midwest Capital Corporation. July 3, 1985, St. Paul, Minnesota

Underground Economy

- 62% of the sample felt that there was no "effective way" to tax the underground economy, but a number of respondents suggested national sales taxes, value-added taxes, prohibitions of second party check cashing, and reducing bank cash transaction reporting levels as methods of reaching the underground economy.

Depreciation Recognition

- 80% opposed the proposed changes in ACRS while 15% favored.

Effect on Firm

- 58% concluded that the proposal, if enacted as proposed, would negatively affect their firm. Only 11% thought their firm would be favorably affected. Many mentioned lesser cash flows resulting from investment tax credit and depreciation changes. But, 58% (not necessarily the same respondents) thought the proposal was "fair" to their firm as compared to other firms.

Effect on Industry

- 57% perceived the proposal as unfavorable to their industry. (Numerous industries are in the sample.)
- 71% perceived the proposal as "harmful" to the Midwest, while 3% thought the proposal as drafted, favored the region. However, the proposal was perceived as "fair" to the Midwest by a 49% to 33% margin.

Raising Capital

Respondents were asked to disclose anticipated sources of capital for future growth.

69% - internally generated
22% - debt
17% - private placements
2% - public offerings

(some respondents indicated more than one source)

We've concluded that the initial responses demonstrate the need to review the proposal's effects on profitability and the ability to generate funds for investment because:

- 37% felt the proposal would not affect the way they could raise capital in the future.
- 37% were unsure.
- 26% felt the proposal would result in a decrease in investment.
- 0% (none) felt the proposal would result in increases in their planned investments.

The MACI Small Business Council has reviewed the proposal. They conclude that certainty and predictability of tax laws are especially important for smaller enterprises. Therefore, whatever reform measures are adopted should include appropriate delayed effective dates and transition periods so that pending transactions can proceed and development projects can continue. Businesses and investors will thus be able to restructure their operations, change the focus of their investments and business activity. Abrupt tax changes can and do bring about confusion and uncertainty, triggering liquidations and business failures and with them, the loss of goods and services to the economy. More importantly, employment is jeopardized with considerable personal and social disruption.

We have concluded that the seemingly paradoxical responses indicate that our business constituency wants tax reform and we encourage you to press on with efforts to make the proposal even more economically and administratively efficient.

The membership response indicates that we support your efforts to amend the tax code to provide a growth environment for capital formation--the investment in human and physical capital--and a growth environment for the creation of quality jobs.

Senator DURENBERGER. Thank you very much. Our next panel consists of five eminent State and local government officials who are here to address how tax reform will affect the public sector in Minnesota.

The first is Hon. Roger Moe, the majority leader of the Minnesota State Senate, and in charge of the senate Committee on Rules and Regulations. Roger, welcome. You know what the rules of speaking are here. I know this is your building, but it's my hearing.

TESTIMONY OF ROGER D. MOE, MAJORITY LEADER, MINNESOTA STATE SENATE; BILL SCHREIBER, MINNESOTA HOUSE OF REPRESENTATIVES; GEORGE LATIMER, MAYOR, ST. PAUL, MN; JEAN OLSON, PRESIDENT, MINNESOTA SCHOOL BOARDS ASSOCIATION; AND JAY KIEDROWSKI, COMMISSIONER, MINNESOTA DEPARTMENT OF FINANCE

Mr. MOE. Thank you, Senator Durenberger. My name is Roger Moe and I am a State senator and majority leader in the Minnesota Senate and just so that all of you know, that was the tradeoff, I got a chance to testify in exchange for using the room.

And, Senator, just as the people that have started to gather out on the mall of this capitol today and perhaps through the rest of the weekend have an intimate link to the first American Revolution, I suspect the crowd in this group today have an intimate link with the second revolution.

I do want to thank you for conducting this hearing in Minnesota, for the opportunity to testify on President Reagan's tax reform proposal. I also must commend you for your support of the deduction for State and local taxes.

Let me begin by expressing my support for tax reform.

Minnesota's income tax like every other State is unextractably linked to the Internal Revenue Code.

Because of these ties our State income tax can be no more fair than the Federal income tax, no simpler than the Federal income tax and no more conducive to growth than the Federal income tax. Any major reform at the Federal level will, therefore, also pay dividends for State taxpayers.

But, I'm here today not to endorse what President Reagan has called his second American revolution, but rather to warn what Business Week has called the new war between the States. What is at issue is the very structure of our federal system and beyond that the issue of the role of Government in today's society.

Earlier in his first term, President Reagan offered a set of sweeping proposals under the heading of New Federalism, a sorting out of State and Federal responsibilities in revenues.

Over the past few years we have seen what this sorting out of responsibilities really means. Budget cuts which force State and local governments to pick up the slack.

Minnesota State and local governments accepted that challenge and made the tough decisions. Reagan's New Federalism costs over $500 million in Federal aid. We ate it and we kept our budgets balanced.

Now, the New Federalism has shifted to the revenue side, by eliminating the deduction of State and local taxes the President wants to limit the ability of State and local governments to accept responsibilities which the Federal Government has abdicated.

The President wants to reduce the Federal deficit on the backs of State and local taxpayers.

Each year the Federal budget gets more and more out of control. Last count the Federal Government was spending $1 for every 76 cents it takes in.

On the other hand, during the last recession, Minnesota held seven special sessions to keep our budget balanced, we raised taxes and cut spending when we had to. By making those tough choices a few years ago we were able to cut taxes by $866 million this year.

Plainly and simply Minnesota State and local governments work, the Federal Government does not and we do not want or need anymore of those problems at the State level.

In addition to President Reagan's New Federalism, the Federal Government has given us a national recession which severely restricted the revenue flow in the State treasuries yet our economy is strong. The Federal Government has given us the largest national deficit in the history of our Nation yet our budgets are balanced.

The Federal Government has given us a trade deficit that has severely tightened credit and overvalued the U.S. dollar resulting in predictions that as many as 13,000 Minnesota farmers or 17 farmers a day will be driven off their lands over the next 2 years, yet, Minnesota managed to provide substantial property and sales tax relief to our farmers this past year.

Now, Mr. Chairman, the Federal Government wants to reform a tax system that no longer works and again do it on the backs of State and local government and their taxpayers.

We have taken the problems that the Federal Government has given us and dealt with them. We now challenge the Federal Government to deal with its own problems and not pass them on to the State.

In Minnesota we have maintained our commitment to equal and quality public education, it's estimated that the President's tax proposal will force States to cut its aid to education and in Minnesota that's estimated to be about 20 percent. Our schools work, don't diminish the educational opportunities for our children. Our governments have had a difficult time maintaining our excellent infrastructure, don't destroy their major funding source by eliminating revenue bonds. We have rebuilt our central cities, don't take away the tools we use to maintain them and, finally, in Minnesota we have not turned our backs on the most vulnerable people among us, the poor, unemployed, the elderly and the sick, don't force us to do that.

Senator, we have coped with our problems, including the ones the Federal Government has given us, it's now time for Washington to make some of the tough decisions on its own.

Senator, finally let me just say that in my observation of all of this over the past 15 years, there are only two times when you can have significant reforms occurring: One is when you have the revenues to be able to buy out those reforms; and second, when you are put in a position similar to what the Federal Government is put into where you really have to make some significant reforms. We were lucky enough in Minnesota to have the revenues to be able to afford to buy out some significant reforms. You don't have that luxury and I realize that your job is going to be many, many times harder than the job that the representative and I had to wrestle with over these past few months. So all I can say is good luck to you.

Senator **Durenberger**. Let me ask you, before you leave, Roger, if you support a constitutional amendment to balance the Federal budget?

Mr. **Moe**. No, I do not.

Senator **Durenberger**. Why, in light of that comment?

Mr. **Moe**. Because I fundamentally believe that the Federal Government ought to have the ability to move within the whole endless list of issues that you have to deal with on a worldwide scale and it's not so much the balancing the budget as it is the amount of the deficit and you know that as well as I do and all the others here, and I think it's the amount that has you quite scared at this time.

Second, I think it's inconsistent for States to ask you for more and more help and then at the same time pass regulations asking you to balance the Federal budget. That's why Minnesota does not do that and we have not as of yet and I will not support that because we come to you for help, Senator, and I think it's inconsistent to ask for help on one hand and then say why don't you balance your budget on the other.

Senator **Durenberger**. Thank you very much. We will next hear from Representative William Schreiber, of Minnesota's House of Representatives, who is the chairman of the House Tax Committee and a member of the Budget and Local and Urban Affairs Committee. Welcome, Bill.

Mr. **Schreiber**. Good morning, Senator. I would like to begin by saying thank you for bringing this hearing to St. Paul, it's much easier for me traveling the 30 minutes than it is to go out to Washington.

Senator **Durenberger**. I thank you for coming out to Washington last week and helping us.

Mr. **Schreiber**. It was kind of fun, I appreciate the good weather.

First of all, I strongly endorse the general thrust of the administration's and congressional efforts to reform the Federal income tax. In general, I believe the reform plans will have a very positive effect on the economy and the fairness of the tax system.

Lowering tax rates will reduce the tax system's influence on economic decisions while simultaneously increasing the incentive to work and save. In my judgment, it is critical that investment and other economic decisions be made on the basis of their economic merits, not their tax advantages.

By eliminating tax preferences and reducing tax rates the overall fairness of the tax system will be enhanced. Individuals with equal income will pay more nearly equal taxes, a fundamental test of fairness.

By simplifying the income tax, taxpayers will be better able to understand and comply with the tax, an important goal of any tax system.

As you may know, in Minnesota we have recently enacted a major reform and simplification of the State income tax, along with a substantial, over 17-percent reduction in the tax. The tax bill repealed over 30 special adjustments, deductions, and credits. However, because the Minnesota tax is so closely tied to the Federal income tax, further reform of the State income tax will largely be dependent upon Federal reform.

I have, however, one important reservation about the President's tax reform proposal. My concern relates to the deductibility of State and local taxes.

I would like to make several points in favor of retention of State and local deductibility. First, in the reform of our State income tax, we retained full deductibility of Federal income, State sales, and local property taxes in the computation of our State income tax base. This decision was based on the fundamental consideration that the income tax base must measure the capacity of ability of the taxpayer to pay tax. Involuntary tax payments, whether they be Federal income taxes, State sales or income taxes, or local property taxes are dollars not available to the taxpayer and should not be used to measure the amount of income available to pay tax.

Second, proponents of the elimination of deductibility argue that it is necessary to eliminate deductibility in order to bring down excessively high State and local taxes. In Minnesota the legislature is willing and able to take these steps, but to do so in the context of the needs of its taxpayers. Each State, I am sure, has unique needs and should have the flexibility to formulate a tax policy that meets those needs. Furthermore, the elimination of the personal deduction for State and local tax deduction will encourage States to restructure their tax systems to tax businesses more heavily, since these taxes will remain deductible as business expenses. I believe this would be unfortunate, since the ultimate incidence of these taxes is difficult to determine at best and may well be regressive. Furthermore, eliminating the personal deductions while retaining the business expense deduction will create the appearance of unfairness.

Third, Minnesota taxpayers have a lot to lose through the loss of deductibility. The savings per taxpayer is 143 percent of the national average. It is argued by some in Washington that other States have a lot to gain. However, those States are by and large the same States which receive more back from the Federal Government than their citizens pay in Federal taxes. In the case of Minnesota, we receive less in grants-in-aid and Federal expenditures than we contribute in taxes. Figures from the Congressional Research show that Minnesotans get back $.87 on each dollar we send the Federal Government.

The need for Federal tax reform is great. But one may question the assertion of some that reform is impossible without sacrificing deductibility. The President's tax reform proposal criticizes the State and local tax deduction as a subsidy of itemizers by nonitemizers and of residents of high tax States by residents of low tax States. Accepting this logic, all itemized deductions, home mortgage, interest, charitable contributions, and so forth, would appear to be a subsidy of itemizers by nonitemizers. I simply do not believe this is the case; it is a fundamental feature of measuring the ability to pay.

However, if it is the case, it bears pointing out that the President's proposal retains other similar "subsidies." One may question why these subsidies should have a higher priority than retention of the State and local tax deduction. Is it more important to encourage taxpayers to borrow money to buy cars, vacation homes, and other goods or to take vacations, provided the interest charges don't exceed $5,000 per year, rather than to pay taxes to provide education for elementary and secondary school children or medical care and minimal income security for the poor? I think no. Fundamentally, it is a matter of priorities and I urge you to give a very high priority to the preservation of a healthy system of federalism by retaining the deductibility of State and local taxes.

Senator DURENBERGER. Bill, thank you very much. Our next member of the panel will be Hon. George Latimer, who has been the mayor of St. Paul since 1976.

Mr. LATIMER. Good morning. I'm George Latimer, I'm the mayor of the city of St. Paul. Thank you very much, Senator, for holding this hearing.

Senator DURENBERGER. I was going to read the rest of your credentials. I suppose everybody else knows about how you chaired the Minnesota Tax Study Commission, the National League of Cities, and I was going to end there.

Mr. LATIMER. Yes, that's good. I try to avoid that because my testimony, of course, will be a rebuke of everything I did in those other enterprises.

You have my statement. I want to make just three or four overview statements, Senator.

We are here for a good reason and not only that the deficit is so vast and so fraught with dangers, but also because what has occurred in the past, at least 6 or 7 years or more is that while we have been neutral and withdrawing on the programmatic side of our cities and people in the cities we actually have been silently and quietly and in some ways surreptitiously and certainly unconsciously to most of the public increasing at a tremendous rate tax expenditures that we make.

To give you one example, in the area of housing, we have decreased our commitment to public housing, subsidized rural rehab credit programs, for all of these traditional housing programs since 1979 the decrease has been in absolute terms 55 percent. So, we have been pretty aggressive there.

The tax expenditure in the housing area has increased 152 percent during that same period.

Now, the important thing about this tax code is to understand that if we don't have an urban policy in effect anymore, and we don't, and if we don't have an environmental policy in America anymore, and we don't, we have to look to the Tax Code for any suggestion of activity that really comes to a major investment on the part of the Federal Government.

The trouble with moving the tax expenditures is twofold. One, the targets are unconscious and not met in many cases so that we know the population we are trying to meet and help in the housing program, we certainly are not meeting that same need for the low to moderate income people in the tax expenditure side. I think that's pretty apparent.

The second thing that Senators understand but most of us don't understand very well, is that there is no lid on the tax expenditure side. You don't hold hearings every year and draw a line and say we are not going to expend more than X number of dollars on the mortgage. So, that's the other thing. It just keeps increasing without any oversight.

About 4 years ago, Senator, you were one of the few people in the Senate who led, I thought, a very careful and worthwhile examination of the New Federalism. I was one of the few mayors in the country who was naive enough to think that effort was worthwhile and you remember those interesting discussions we had about swap and pass through and all the rest, trying to figure out what is a fair allocation of responsibility and resources in this Nation of ours and the city said to me, that's crazy that's just a way of avoiding expenditures and they are not really interested in reforming the way we do our business and I threw myself into it and you did as well. We came up totally empty. We found the New Federalism examination from the administrative side without principle and without any real purpose and without reason except that there were massive cutbacks.

Now, we have a tax reform package being offered and here I am again ready to say there is much good in this and let's really go after a real reform then something else says to me wait 1 minute, you have been there before and something else, to coin a bad phrase, says to me, there he goes again, getting a lot of us folks who really care about government and how it reflects our values to try to retool the Tax Code and act as though that's going to be imbued with values. Taxes tell us about costs, tax expenditures tell us about values. This discussion about the tax reform does not tell us whether we value the air or whether we value the environment or we value our children and I for one am not going to commit myself to a support of a tax reform package unless I have a clear understanding where this Nation and where our leadership and the Senate wishes to go about the allocation of our resources on the expenditure side.

I think that's something we have got to do, I think it should be a profound and important question. I fear it will deteriorate as did the New Federalism discussion. I too salute you for your efforts, I intend not withstanding my remarks to engage in this so long as I am able, but I must say I remain very skeptical until I see a change from the administration on this matter.

Senator DURENBERGER. Thank you very much, George.

Our next witness on this panel is Jean Olson, president of the Minnesota School Boards Association. Jean?

Ms. OLSON. I am Jean Olson, elected member of the Duluth School Board and president of the Minnesota School Boards Association. Thank you for the opportunity to testify as to the current state of education in Minnesota and the impact on education of proposed Federal tax reforms.

Minnesota enjoys a national reputation for excellence in education. Our Governors, legislators, and citizens have a tradition of strong commitment to public education. Taxes and education were the top priorities of the 1985 legislative session. In spite of a significant tax cut, the next biennium will see an increase in spending for K–12 education, with 24 percent of the State budget allocated for education. Citizen polls give schools high grades and indicate a willingness to spend money for education.

In the early 1970's, Minnesota established a school finance formula designed to reduce reliance on local property taxes, based on the belief that a child's education should not depend on the wealth of a local district. This increased reliance on State funding has also made schools vulnerable to fluctuations in the State economy. For example, in 1981 a shortfall in State revenues was passed onto local school districts. Duluth, that year, in an effort to cut $6 million from our budget, which is 14 percent of our total budget, closed 8 schools and laid off 200 employees.

These cuts were necessary in spite of continuing efforts to cut expenditures and to operate more efficiently. State law demands that our meetings and records are open to the public. We are prohibited from deficit spending. Levy limits are set by the State; local districts may, with voter approval, adopt levies in excess of those limits. Voter approval is also necessary for major capital expenditures which require bonding.

Increased costs and increased demands for services indicate a continued need for revenue. We are understandably concerned that proposed tax reforms be evaluated to assess their impact on the ability of the State and local districts to provide stable and adequate funds for education. We are especially concerned about the proposal to eliminate the deduction of State and local taxes on Federal income tax returns.

Clearly this proposal has greater impact on high-tax States. It is important to remember, however, that high taxes pay for a high level of services. Minnesotans, who are willing to support good schools, maintain good roads, and to care for their neighbors, should not be unfairly penalized by the Federal Government.

While the loss of deductibility would not directly affect revenues available for education, immediately, we are concerned that in the long run revenues could be affected. First, taxpayer pressure at the State level could impact State aids to education. If the loss of State aid were cushioned by increases in local levies, we could see further retreat to the funding of education based on the wealth of local districts. Because voters must give referendum approval to excess levies for bonding for major capital improvements, it is very likely that voter frustrations with taxes in general would be expressed by refusing to approve school referenda which reminds me of a poster that suggests that wouldn't it be wonderful if we could have a bake sale to build bombers and have enough money to operate our schools and we face increased problems of this with fewer of our residents who actually have children in school and directly see the need for those improvements.

Our concern, then, is for the indirect effect that the loss of deductibility could have on education revenue. A well-educated public is critical to our economy and essential to our democratic form of government. If public education is to be the responsibility of State and local government, then we must retain the authority to obtain the revenue to provide good schools. While tax reform proposals need to be evaluated on the basis of their overall impact on the economy and on the taxpayer, we ask that you continue to carefully assess the long-term impact on State and local government.

Senator **Durenberger**. OK. Thank you very much, Jean. Our final member of the panel is Jay Kiedrowski, Minnesota Commissioner of Finance. Jay, we are glad you could join us.

Mr. **Kiedrowski**. Thank you, Senator. Before I address tax reform, I believe it's important that I comment on a far greater and more urgent need to the taxpayers and economy of Minnesota—a reduction in the Federal deficit.

Minnesota, whose economy tends to mirror the national economy, is beginning to suffer from the lopsided recovery the Nation is experiencing. The farm and mining sectors of our economy are in recession. Even the computer industry in Minnesota is slowing, reflecting the inability to sell products to a stagnant manufacturing sector. Minnesota and its taxpayers need a substantial reduction in the Federal deficit if we are to have full, sustained economic growth in Minnesota.

The administration's own estimates indicate that the President's proposal would not be revenue neutral, but is a revenue loser which will add billions to the deficit in future years. Any tax reform should at a minimum be revenue neutral. Tax reform discussions must occur in the context of efforts to reduce the deficit.

Now turning to the President's proposal, those of us in Minnesota who have just gone through a fight in reforming taxes are especially sensitive to looking at the general interest of the whole as well as the special interests of the individual constituencies.

In general and in the long run the Reagan tax reform proposal should generate more economic growth in Minnesota. It also attempts to make the system more fair and simple for the whole, that's very positive. But, the President's proposal does cause some legitimate problems, Federal individual income taxes would fall by $450 to $500 million under the Reagan plan, according to estimates made by Minnesota's Department of Revenue.

This is a reduction of $155 to $172 per taxpayer. However, the reduction in Federal taxes on individuals in Minnesota is not proportionately as great as the reduction for the Nation as a whole.

Minnesotans will pay $100 million tax penalties by the removal of the deductibility of the State and local taxes. This penalty will be paid by a minority of our taxpayers, those who itemize, and that minority is approximately 40 to 50 percent of our taxpayers.

Minnesota State government just reformed its State income tax and broadened the tax base and lowered its rates. So, we have done similar things to what is being proposed be done at the Federal level, but Minnesota did not adopt, and indeed never even considered, broadening its tax base and lowering its rates by eliminating the deductibility of taxes of lower units of government. We never even considered it. We think that it's inappropriate that the Federal Government is considering that.

We think it would be desirable to maintain in whole or in part deductibility of State and local taxes in Federal income tax law.

We are prepared to support other revenue-raising measures which will enable the State and local tax deduction to be retained while still significantly lowering marginal rates or reducing the deficit.

In particular, we would call your attention to the energy taxes. Increased energy taxes will in the short run raise revenue to reduce the deficit or to improve the tax reform program.

In the long run, higher energy taxes will encourage conservation, reduce energy waste and strengthen the energy independence of our economy.

Thank you.

Senator DURENBERGER. Jay, why don't you move to your right, if that's philosophically possible.

First, on the issue of deductibility, there are several ways to look at it. If we look at it in the way George was describing—in terms of its describing—tax expenditures and the value of a Federal contribution—you can see that deductibility is a way for the Federal Government to pay taxpayers for paying State and local taxes.

If you are in the 50-percent bracket, for every dollar of State or local tax you pay, the Federal Government matches with a half buck. That's sort of the way it works. If you are in the 25-percent bracket, the Federal Government gives you a quarter for every dollar you spend, and some States spend more than others. So, their matching rates are different.

Now, the difference between Minnesota and South Dakota, is, for example: If you combine the Federal and State and local tax burdens on a Minnesotan, the marginal rate is 54.3 percent at the highest bracket, 54.3 percent combined.

In South Dakota, it's 50 percent. Now, I bet a lot of people thought it was more than that, but that is the combination.

If you eliminate deductibility, however, and you pass the President's plan—a 35, 25, 15—then Minnesotans drop from 54 to 45.4. But South Dakotans drop from 50 to 35 percent.

So, the difference between the taxpayers in each State widens by over 6 percent, to a 10.4-percent spread.

Now, there are other ways for us to do that. I suppose we could go back to the appropriations system that George says we are leaving, the direct appropriation. We can change the Federal formulas for Medicaid and AFDC and a whole lot of other things. We can just put more money on the basis of a tax effort, or something like that, into a Minnesota—to match its tax efforts or tax capacity—than we put into a South Dakota.

Let me make one other comparison just so we all understand it. What surprised me is that the difference, nationwide, between the combined State and local tax burdens on a resident of a central city—a St. Paul or a Minneapolis—and the same person in a suburb is 37 percent. The Federal deduction for State and local taxes helps cities, like St. Paul, where on the fairness principle, you as a citizen pay taxes for services such as police and fire protection. In St. Paul or in White Bear Lake, it's the same thing. Fairness says that if you have a similar income then you get similar services, and you ought to be similarly taxed.

But the reality is that you are taxed with a 37-percent disparity, which we help to alleviate with deductibility.

But there are other ways to do it. My question is: Are there not better ways to alleviate disparity?

Mr. **Latimer**. Senator, may I comment on that? First of all, would everyone in the room who understands that last statement raise your hand? We are going to test you on that disparity.

I think you are moving in a direction, I think we agree that the deductibility feature encourages the self-reliance which this administration has been asking of States and local government.

And that, therefore, it's inconsistent to take away the deductibility feature on the Federal level. If, however, to follow your path, you do choose to go that way, it seems to me that you are unsuccessfully but raising some interesting issues in your general revenue sharing analysis and my response to the President's position on taking away our tax effort as a benefit is to say, OK, then let's play on an even playing field and let's go to West Pack and the oil-producing and mineral-producing States and take that part of their effort which is borne by the Nation through severance taxes and through the rest and crank that into a deductibility formula.

Now, you can do it through the front door that way and therefore you would have a larger pool into the Federal revenue at the front end or you could do it along the lines you were suggesting at the distribution end, I would think that the politics of it are probably equally difficult, but I think it's more of a political issue than a mathematical issue, I think you probably have the ability to crank out based on some of the stuff you did for general revenue sharing to, to crank out some similar kinds of tax effort being made indirectly by the people who are rich in minerals and fossil fuels.

And now I will ask everyone who understands my statement to raise their hands.

Senator **Durenberger**. I was going to do that. The other reality is that you cannot get that done. I mean, you all know what happened to me when I proposed a restraint on the taxation of coals. We were paying Montana's taxes for them and North Dakota's taxes for them every time we turned on a light switch. You cannot pass that kind of legislation.

Mr. **Latimer**. That takes you back to the original position which I think you hold and we hold and that is the only fair thing to do if we are, ask States and cities to be more self-reliant, not to penalize them for exercising that self-reliance and using their own resources.

In Minnesota we don't have gas and oil and therefore we tax what we are rich in and that's people and productivity and we tax them high and so we have got to be rewarded for that self-reliance instead of penalized.

Senator **Durenberger**. Let me ask the people at the State level, particularly, a question about how we tax ourselves in Minnesota.

One of the promises of the New Federalism in 1982 was that we would devolve responsibility on State and local government, which was welcomed by State and local government. Then we would also devolve the resources to go with it.

Now, we haven't done a very good job of that devolution. We have raised gas tax at the Federal level; we have raised cigarette tax at the Federal level; we have certainly raised the payroll taxes. I think by 1999 the Social Security tax will be about $8,000 per person per year, at most. So, we haven't showed a lot of restraint.

But, on the other hand, only 27 States in this country permit local governments to raise sales taxes generally, and only four States permit local government to get at the income tax.

I wonder why Minnesota State government has not freed up its local governments to a greater degree, in order to generate their own sources of revenue, as some other States have?

Maybe you want to pass that onto the elected officials?

Mr. **Schreiber**. It's not that those proposals have not surfaced. In fact, I believe Citizen's Need suggested some type of sharing of the sales tax base, but quite frankly, you know, the communities are not enough alike. You know, you have the Minneapolis and St. Paul and Bloomingtons and Edinas which are varied neighborhoods with very large employment bases. If you have some type of payroll tax within those communities it would obviously be quite windfall for those communities.

On the other hand, you have the more bedroom communities that have nothing there but single family homes and perhaps not even shopping centers. Their only wealth is their people and their homes.

So, from an equity standpoint we have really just avoided that suggestion like the plague, that we have allowed communities to either extend their sales tax or some type of income tax. We feel that we can treat people much more fairly and equally through local government agencies and school agencies and I think that's for Minnesota.

Mr. **Kiedrowski**. If I might respond as well, over 50 percent of the State budget is transfer payments to local government. I think you need to have that fact in mind.

Senator **Durenberger**. I understand that, but that doesn't give George the option to make his own decision with his own money. You tell him how to spend that money, do you not?

Mr. **Kiedrowski**. No, we don't. Most of the transfer payments in fact are block grants which he then has the authority to disperse however he would like. And he does utilize that flexibility

Senator **Durenberger**. Jean?

Ms. **Olson**. Senator, in terms of the school finance I think that the State has done a very fine job and has addressed the equity issue in terms of deciding on formulas which is heavily reliant on State efforts. Above that they do allow local district support or approval to have excess levy revenues. They also have a variety of permissive levies, for example, new efforts in early childhood education are going to be a local district effort, started at the local level and levied for the local level, but I would personally not like to see them retreat from that equity issue in terms of school finance.

Senator **Durenberger**. I need to get some view on tax-exempt bonds financing and to see if there is any consensus here in Minnesota. It is clear, as you travel this State, that IDB's are being used, in some part, to move a business out of East Grand Forks and into Crookston, or from Crookston into East Grand Forks, or from Roger's district to Jerry Willis' district, for example. I don't know what that adds to anything. IDB's are used to help finance some of the major restaurant subsidiaries and some of our large food-processing companies built in various communities of the State. They seem to have an effect on the value in the market of the general obligation bonds that are needed for sewers and water, and highways, and so forth. But Minnesota has always found some creative way to use these things and maximize their benefit.

The President is recommending that we get rid of a heck of a lot of tax-exempt bond financing.

The struggle out there this year, I assume, will be to try to define the public, as opposed to private, purpose. I think we have a witness who might talk about this in greater detail later. But while we have some political, elected types here, do you have some views that you would like to share with me, at this point, on where we ought to be going if we are to start curtailing these investment tools?

By the same token, most of the analysis of this tax bill tells me that the capital investment incentives are in the direction of the high-technology edge and away from housing and that kind of development, which may well be a problem for us.

Mr. SCHREIBER. Let me take a stab at this. I think there is general consensus that the administration's definition leaves something to be desired and that 1 percent of the proceeds are going to any private entity would then become a private purpose is simply ridiculous.

Senator DURENBERGER. That would hurt us in the small towns, for example, because one new employer is probably going to account for 10 percent of the employment in that town.

Mr. SCHREIBER. And if one airline used the airport it would probably be a private purpose rather than a public purpose. So, from a definition standpoint this proposal leaves something to be desired and on the other hand I think it's severely important that you restrict the supply of tax exempt products and I'm going to put on my government hat now and stay away from the underwriters and bonders and so on. But, it seems to me that if the margin rate is going to 50 percent down to 35 percent margin you now have less of an incentive in order to purchase a tax exempt bond. If you keep a large supply of tax exempt bonds in the market it simply means that the spread between the taxable bond and the tax exempt bond is going to become narrow and that can only mean that costs are going to increase to school districts when they have to finance schools or cities when they are putting in sewers or water and streets and so on in the State of Minnesota as it relates to all of our capital projects. So, although I disagree with the administration's definition, I do agree that it's very important that you restrict the supply of tax-exempt bonds because if you don't it's a part of this overall package, those of us that are supportive of local uses of the government are simply going to see a rather significant increase in interest rates at that rate.

Senator DURENBERGER. All right. Thank you very much, Jean and gentlemen. Thank you very much for your testimony. I appreciate it a great deal.

[Prepared statements of Messrs. Moe, Schreiber, Latimer, Kiedrowski, and Ms. Olson follow:]

JULY 3, 1985
STATEMENT ON PRESIDENT REAGAN'S TAX REFORM PROPOSAL
SENATOR ROGER D. MOE, MAJORITY LEADER

MR. CHAIRMAN, MY NAME IS ROGER MOE. I AM STATE SENATOR AND MAJORITY LEADER OF THE MINNESOTA SENATE.

I WOULD LIKE TO FIRST THANK YOU FOR CONDUCTING THIS HEARING IN MINNESOTA AND FOR THE OPPORTUNITY TO TESTIFY ON PRESIDENT REAGAN'S TAX REFORM PROPOSAL. I ALSO MUST COMMEND YOU FOR YOUR SUPPORT OF THE DEDUCTION FOR STATE AND LOCAL TAXES.

LET ME BEGIN BY EXPRESSING MY SUPPORT FOR TAX REFORM. MINNESOTA'S INCOME TAX, LIKE THAT OF EVERY STATE, IS INEXTRICABLY LINKED TO THE INTERNAL REVENUE CODE. BECAUSE OF THESE TIES, OUR STATE INCOME TAX CAN BE NO MORE FAIR THAN THE FEDERAL INCOME TAX, NO SIMPLER THAN THE FEDERAL INCOME TAX, AND NO MORE CONDUCIVE TO GROWTH THAN THE FEDERAL INCOME TAX. ANY MAJOR REFORM AT THE FEDERAL LEVEL WILL THEREFORE ALSO PAY DIVIDENDS FOR STATE TAXPAYERS.

BUT I AM HERE TODAY NOT TO ENDORSE WHAT PRESIDENT REAGAN HAS CALLED HIS "SECOND AMERICAN REVOLUTION" BUT RATHER TO WARN OF WHAT BUSINESS WEEK HAS CALLED "THE NEW WAR BETWEEN THE STATES." WHAT IS AT ISSUE IS THE VERY STRUCTURE OF OUR FEDERAL SYSTEM AND, BEYOND THAT, THE ISSUE OF THE ROLE OF GOVERNMENT IN TODAY'S SOCIETY.

EARLY IN HIS FIRST TERM, PRESIDENT REAGAN OFFERED A SET OF SWEEPING PROPOSALS UNDER THE HEADING OF "NEW FEDERALISM"; A SORTING-OUT OF STATE AND FEDERAL RESPONSIBILITIES AND REVENUES. OVER THE PAST FEW YEARS, WE HAVE SEEN WHAT THIS SORTING OUT OF RESPONSIBILITIES REALLY MEANS: BUDGET CUTS WHICH FORCE STATE AND LOCAL GOVERNMENTS TO PICK UP THE SLACK.

BUT MINNESOTA'S STATE AND LOCAL GOVERNMENTS ACCEPTED THAT CHALLENGE, AND MADE THE TOUGH DECISIONS. REAGAN'S NEW FEDERALISM COST US OVER $500 MILLION IN FEDERAL AID. WE ATE IT, AND KEPT OUR BUDGET BALANCED.

NOW "NEW FEDERALISM" HAS SHIFTED TO THE REVENUE SIDE. BY ELIMINATING THE DEDUCTION FOR STATE AND LOCAL TAXES, THE PRESIDENT WANTS TO LIMIT THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO ACCEPT RESPONSIBILITIES WHICH THE FEDERAL GOVERNMENT HAS ABDICATED. THE PRESIDENT WANTS TO REDUCE THE FEDERAL DEFICIT ON THE BACKS OF STATE AND LOCAL TAXPAYERS.

EACH YEAR, THE FEDERAL BUDGET GETS MORE AND MORE OUT OF CONTROL. AT LAST COUNT, THE FEDERAL GOVERNMENT WAS SPENDING ONE DOLLAR FOR EVERY 76 CENTS IT TAKES IN. ON THE OTHER HAND, DURING THE LAST RECESSION, MINNESOTA HELD SEVEN SPECIAL SESSIONS TO KEEP OUR BUDGET BALANCED. WE RAISED TAXES AND CUT SPENDING WHEN WE HAD TO. AND, BY MAKING THOSE TOUGH CHOICES A FEW YEARS AGO, WE WERE ABLE TO CUT TAXES BY $866 MILLION THIS YEAR.

PLAINLY AND SIMPLY, MINNESOTA'S STATE AND LOCAL GOVERNMENTS WORK. THE FEDERAL GOVERNMENT DOES NOT. AND WE DO NOT WANT OR NEED ANY MORE OF THOSE PROBLEMS AT THE STATE LEVEL.

IN ADDITION TO PRESIDENT REAGAN'S NEW FEDERALISM, THE FEDERAL GOVERNMENT ALSO GAVE US A NATIONAL RECESSION WHICH SEVERELY RESTRICTED THE REVENUE FLOW INTO STATE TREASURIES. YET, OUR ECONOMY IS STRONG.

THE FEDERAL GOVERNMENT HAS GIVEN US THE LARGEST NATIONAL DEFICIT IN THE HISTORY OF OUR NATION. YET, OUR BUDGETS ARE BALANCED.

THE FEDERAL GOVERNMENT HAS GIVEN US A TRADE DEFICIT THAT HAS SEVERELY TIGHTENED CREDIT AND OVERVALUED THE U.S. DOLLAR RESULTING IN PREDICTIONS THAT AS MANY AS 13,000 MINNESOTA FARMERS -- OR 17 FARMERS A DAY -- WILL BE DRIVEN OFF THEIR LAND IN THE NEXT TWO YEARS. YET, MINNESOTA MANAGED TO PROVIDE SUBSTANTIAL PROPERTY AND SALES TAX RELIEF TO OUR FARMERS.

AND, NOW, MR. CHAIRMAN, THE FEDERAL GOVERNMENT WANTS TO REFORM A TAX SYSTEM THAT NO LONGER WORKS AND AGAIN TO DO IT ON THE BACKS OF STATE AND LOCAL GOVERNMENT AND THEIR TAXPAYERS.

WE'VE TAKEN THE PROBLEMS YOU HAVE GIVEN US AND DEALT WITH THEM -- WE NOW CHALLENGE THE FEDERAL GOVERNMENT TO DEAL WITH IT'S OWN PROBLEMS AND NOT TO PASS THEM ON TO US.

IN MINNESOTA, WE HAVE MAINTAINED OUR COMMITMENT TO EQUAL AND QUALITY PUBLIC EDUCATION. IT IS ESTIMATED THAT REAGAN'S TAX PROPOSAL WILL CUT EDUCATION REVENUE BY 20%. OUR SCHOOLS WORK -- DON'T DIMINISH THE EDUCATIONAL OPPORTUNITIES FOR OUR CHILDREN.

OUR GOVERNMENTS HAVE HAD A DIFFICULT TIME MAINTAINING OUR EXCELLENT INFRASTRUCTURE -- DON'T DESTROY THEIR MAJOR FINANCING SOURCE BY ELIMINATING REVENUE BONDS.

WE HAVE REBUILT OUR CENTRAL CITIES -- DON'T TAKE AWAY THE TOOLS WE USE TO MAINTAIN THEM.

AND FINALLY, IN MINNESOTA, WE HAVE NOT TURNED OUR BACKS ON THE MOST VULNERABLE PEOPLE AMONG US -- THE POOR, THE UNEMPLOYED, THE ELDERLY AND THE DISABLED. DON'T FORCE US TO DO THAT.

SENATOR DURENBERGER, WE HAVE COPED WITH OUR PROBLEMS, INCLUDING THE ONES THE FEDERAL GOVERNMENT GAVE TO US. IT IS TIME WASHINGTON MADE SOME TOUGH DECISIONS OF ITS OWN.

Prepared Statement of Bill Schreiber

Mr. Chairman, my name is Bill Schreiber. I serve as a member of the Minnesota House of Representatives and am the chairman of the House Tax Committee. I would like to thank you for holding hearings on federal tax reform and giving Minnesotans the opportunity to testify on this very important issue.

First of all, I strongly endorse the general thrust of the Administration's and congressional efforts to reform the federal income tax. In general, I believe the reform plans will have a very positive effect on the economy and the fairness of the tax system.

(1) Lowering tax rates will reduce the tax system's influence upon economic decisions while simultaneously increasing the incentive to work and save. In my judgement, it is critical that investment and other economic decisions be made on the basis of their economic merits, not their tax advantages.

(2) By eliminating tax preferences and reducing tax rates the overall fairness of the tax system will be enhanced. Individuals with equal income will pay more nearly equal taxes, a fundamental test of fairness.

(3) By simplifying the income tax taxpayers will be better able to understand and comply with the tax, an important goal of any tax system.

As you may know, in Minnesota we have recently enacted a major reform and simplification of the state income tax, along with a substantial (over 17%) reduction in the tax. The tax bill repealed over 30 special adjustments, deductions, and credits. However, because the Minnesota tax is so closely tied to the federal income tax, further reform of the state tax will largely be dependent upon federal reform.

I have, however. one important reservation about the President's tax reform proposal. My concern relates to the deductibility of state and local taxes. Your thoughtful and strong statements in support of deductibility as an essential componenet of federalism have added clarity to the debate on this important issue.

I would like to make several points in favor of retention of state and local deductibility. First, in the reform of our state income tax. we retained full deductibility of federal income, state sales, and local property taxes in the computation of our state income tax base. This decision was based on the fundamental consideration that the income tax base must measure the capacity of ability of the taxpayer to pay tax. Involuntary tax payments. whether they be federal income taxes. state sales or income taxes. or local property taxes are dollars not available to the taxpayer and should not be used to measure the amount of income available to pay tax.

Second. proponents of the elimination of deductibility argue that it is necessary to eliminate deductibility in order to bring down excessively high state and local taxes. In Minnesota the legislature is willing and able to take those steps, but to do so in the context of the needs of its taxpayers. The recently enacted state budget substantially reduced state taxes and reduced the rate of growth in state spending. The last recession has taught us that Minnesota is changing. and that to maintain our position as one of the more reliable and consistently performing state economies. we had to make changes to attract new industries. to encourage the development of new industries within our state. and to reshape our tax laws to meet these needs. Each state I am sure. has unique needs and should have the flexibility to formulate a tax policy that meets those needs. Furthermore, the elimination of the personal deduction for state and local tax deduction will encourage states to restructure their tax systems to tax businesses more heavily, since these taxes will remain deductible as business expenses. I believe this would be unfortunate, since the ultimate incidence of these taxes is difficult to determine at best and may well be regressive. Furthermore, eliminating the personal deductions while retaining the business expense deduction will create the appearance of unfairness.

Thirdly, Minnesota taxpayers have a lot to lose through the loss of deductibility. The savings per taxpayer is 143% of the national average. It is argued by some in Washington that other states have a lot to gain. However those states are by and large the same states which receive more back from the federal government than their citizens pay in federal taxes. In the case of Minnesota, we receive less in grants-in-aid than we contribute in taxes. figures from the Congressional Research show that Minnesotans get back $.87 on each dollar we send the federal government.

Elimination of the deductibilty of state and local taxes will affect the ability of state and local governments to raise revenues. This would occur at the same time that the federal budget is very likely to reduce grants-in-aid to state and local governments as part of the deficit reduction effort. The President's budget recommended that state and local government grants-in-aid be cut by about $7 billion or 6 percent in nominal dollars over fiscal year 1985. Since inflation is estimated by the administration to be increasing at an annual rate of 4.3 per cent, this is a much more significant cut in real terms.

If one views the deduction for state and local taxes as a tax expenditure--and I realize the tax expenditure concept is a somewhat controversial topic--this would constitute an additional loss of approximately $36 billion, again using the President's budget estimates. To me as a state official this seems like adding insult to injury or being asked to give at home after giving at the office.

We are a nation which relies heavily on state and local governments to provide a substantial share of government services--many of which are income sensitive such as medical care and income security for the poor--some form of equalization of the capacity to provide those services is essential. For example in Minnesota we have essentially two economies, one in the Minneapolis-St. Paul metropolitan area which is fairly healthy and provides by far the most significant share of state revenues relative to population. The second economy consists of the remainder of the state--the agricultural areas and the iron range--which are far from healthy. State tax revenues garnared from individuals and businesses in the metropolitan area are used substantially to provide governmental services to outstate region for education and welfare aids. Elimination of the deductibility of state income and sales taxes is likely to erode the willingness of taxpayers in the metropolitan area to "subsidize" those in the other areas of the state where economic activity is lagging. The deduction for state and local taxes may not be a perfect euqalization device, but it is the best that we have and should not be abandoned until we have something much better to replace it.

I would like to comment on the proposals which you have made in regard to deductibility. You have offered it with the fullest expressions of support for the principle of deductibility, and you have structured it in a way which preserves a good measure of the evening out among states with varying tax rates which it now provides. Your proposal also strikes a balance between the assertions of the Treasury Department about $33 billion in revenues foregone by reducing the cost of the deduction. You also keep all taxes in the package, preventing the unintended outcome of states shifting the structure of their tax base to take advantage of the remaining deductibility.

The need for federal tax reform is great. But one may question the assertion of some that reform is impossible without sacrificing deductibility. The President's tax reform proposal criticizes the state and local tax deduction as a subsidy of itemizers by nonitemizers and of residents of high tax states by residents of low tax states. Accepting this logic, all itemized deductions (home mortgage interest, charitable contributions, and so forth) would appear to be a subsidy of itemizers by nonitemizers. I simply do not believe this is the case; it is a fundamental feature of measuring the ability to pay.

However, if it is the case, it bears pointing out that the President's proposal retains other similar "subsidies". One may question why these "subsidies" should have a higher priority than retention of the state and local tax deduction. Is it more important to encourage taxpayers to borrow money to buy cars, vacation homes, and other goods or to take vacations (provided the interest charges don't exceed $5,000 per year), rather than to pay taxes to provide education for elementary and secondary school children or medical care and minimal income security for the poor? I think not. Fundamentally, it is a matter of priorities and I urge you to give a very high priority to the preservation of a healthy system of federalism by retaining the deductibility of state and local taxes.

Thank you. I'd be glad to answer any questions you might have.

PRESIDENT REAGAN'S 1985 TAX REFORM PROPOSAL

STATEMENT OF MAYOR GEORGE LATIMER

BEFORE SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS

SAINT PAUL, MINNESOTA

JULY 3, 1985

The President's tax reform proposals for "Fairness, Growth and Simplicity" (May 1985) cannot and should not be discussed only in the narrow, technical terms of "efficiency", "neutrality", "simplicity". To be understood and evaluated, they must be viewed against the larger backdrop of what we, as a society, are doing to distribute our shared wealth and resources to improve the general welfare of our people.

Since 1979, we have witnessed reductions or freezes in virtually all direct federal assistance programs to urban governments, while at the same time, tax expenditures in the areas of housing, economic development, transportation, employment, income security, infrastructure and other activities related to the well being of urban areas have increased dramatically. (1) As a result:

(i) The federal tax code is now one of the most important vehicles through which the federal government channels capital to urban communities; and the Senate Finance and House Ways and Means Committees have, through their tax writing activities, have become leading architects of urban policy;

(ii) Because there exists neither the will nor the technology to target tax expenditures as sharply as direct assistance programs to specific geographic areas or groups of people, we have witnessed in recent years a redirecting of our nation's wealth away from the poor and the needy to corporations and the middle class. (2)

Two points about these developments are worth highlighting.

First, the President's proposals for tax reform will have dramatic direct and indirect effects of the flow of capital to the people, the institutions (artistic, philanthropic, educational), the industries (big, small, yet-to-be) and the projects that are important to the economic growth and cultural vitality of cities. Not just to cities as units of government; but to cities as economies, as groupings of neighborhood communities, as centers of employment and intellectural exchange and as physical places. (3)

Secondly, these effects of the President's tax reform proposal are, by themselves, neither fair nor unfair. They alone do not resolve the question of whether we, as a society, are being fair or unfair in institutionalizing part or all of the President's 461-page proposal. To make that assessment, we have to ask: "What other steps is the federal government taking concurrent with the reform of its tax code? What direct assistance programs is the federal government putting into place to ensure that, net of the direct and indirect effects of tax reform, adequate resources are being directed to the poor; to the needy; to the urban communities that house and support and employ the poor and the needy?

In 1982, you, Senator Durenburger, and I were among the few senators and mayors who were willing to look at the President's "New Federalism" proposals on their own merits; to concentrate on what we saw as an opportunity to redistribute responsibilities across different levels of government; to ask, "Who ought to deliver what services so that the needs of our people can be met more effectively and efficiently?" Subsequent events have proven us, perhaps, a bit naive. I am not willing to go down that road again. The merits of the President's proposals for tax reform cannot be discussed without asking what the federal government will be doing for the poor, the needy and the cities in which they live. To do so would be as empty as "discussing the Play without Hamlet".

The current budget debate and the ongoing growth of the federal deficit magnify the importance of taking this larger view. This year's budget, even more than those of recent years, proposes yet another round of cuts in general revenue sharing, urban development block grants, community development block grants.

The much debated "revenue neutrality" of the President's tax reform proposals will leave huge overhanging federal budget deficits for much of the next decade -- perhaps longer. With this as a backdrop, it doesn't take a particularly vivid imagination to suggest that any changes, post tax reform, in the federal government's direct assistance efforts are likely to channel less, not more, of the nation's resources to the poor and the needy.

Which brings me to one final set of points.

The President's approach to tax reform is at odds in several key respects with the urban policy, or lack of it, implicit in his recent budgets and in his handling of the federal deficit.

Since 1982, the President's thrust has been to "turn back" to local units of government responsibility and accountability for a growing array of services. (4) Despite this policy direction, we are now facing a tax reform proposal that in two respects -- by eliminating deductibility of state and local taxes and by eliminating tax exemption for interest on all but a narrow range of state and local government debt obligations -- obstructs state and local government access to the revenues necessary to support those services.

"New Federalism" called for increased initiative at the local government level. Yet elimination of deductibility for state and local taxes -- by increasing the relative cost of public sector services -- will penalize precisely those states and cities who have accepted most directly and immediately the responsibilities and challenges embodied in the President's new federalism initiative, his recent budgets and his approach to the federal deficit.

The President's tax reform proposals work against the incentive for state and local government to accept increased responsibility for meeting the needs of our people.

Finally, if we are to eliminate deductibility, let's make sure we do it in a way that doesn't fall unevenly across states and regions. In Minnesota and Saint Paul, we have accepted responsibility for services and programs from which the federal government has withdrawn by taxing our wealth -- our people. States like Texas, Montana, North Dakota and others whose wealth lies in their natural resources have been able to pass on to the rest of the nation -- through the imposition of severance taxes -- the cost of the increasing responsibilities of state and local government. The elimination of deductibility will increase the disparity between the cost of public services in states where they are financed by personal taxes and states where they are financed by severance taxes on natural resources.

NOTES

(1) Since 1979, there has been a dramatic decrease in the dollar amount of direct assistance the federal government allocates to cities for specific purposes (economic development, housing, jobs, pollution control, fiscal assistance to state and local governments and energy), and a corresponding increase in the tax expenditures going for those same purposes.

In the economic development area, programs such as the National Development Bank, the EDA, local public works, and the Rural Development and Business Assistance programs have tumbled from a 1979 funding level of $2,377,000 to a 1984 level of $1,173,000, a 51% cut in the amount of direct assistance afforded to economic development activities. During the same time period, tax expenditures for economic development, the revenue loss associated with the issuance of small issue industrial development bonds, has increased from its 1979 level of $585,000,000 to a 1945 level of $2,155,000, a 268% increase.

In housing, the expenditures for public housing, subsidized housing, rural housing and rehabilitation and housing credit programs have declined from a 1979 level of $30,334,000 to a 1984 level of $13,564,000, a 55% reduction in five short years. During this same time period, tax expenditures for housing bonds, mortgage interest deductions (including deductions on both principal and secondary homes), property tax deductions, expensing and depreciation allowances for housing development, deferral of capital gains and the rehabilitation and historic tax credits have accounted for the 152% growth from the 1979 tax expenditure level of $28,300,000 to the 1984 level of $71,310,000.

As the federal government has substantially reduced direct assistance for job programs, including the elimination of the CETA program and the reduction in employment and training assistance funds from a 1979 level of $11,694,000 to a 1984 level of $3,583,000 a 69% reduction, the tax expenditure side of the jobs picture has grown remarkably. In 1979, federal tax expenditures for job credits were at $15,000,000. The 1984 level of $1,015,000 reflects a staggering 6,667% increase in the use of tax expenditures to stimulate employment. Most of this growth is accounted for the establishment of targeted tax job credits.

In the pollution control area the growth continues. In 1979 direct federal assistance for pollution control activities, including waste water construction grants and hazardous waste assistance programs, totaled $5,415,000. By 1984, this direct assistance number had been reduced by 48% to $2,825,000. The expenditure side of the equation has enjoyed a 220% increase from a 1979 level of $415,000,000 to the 1985 level of $1,300,000.

When we examine the traditional federal aid to urban government programs such as general revenue sharing and targeted fiscal assistance, we discover that the federal government has reduced direct aid to cities by 36% since 1979. During this same five-year period, the exclusion of interest on general obligation bonds and the deductibility of state and local taxes have caused federal tax expenditures assisting cities to grow by 94% from their 1979 level of 6,300,000 to the 1984 level of $31,630,000 of tax expenditures.

(2) This is most evident, perhaps, in the area of housing, where such direct assistance programs targeted to specific income groups (public housing, section 8 and others) have been frozen, reduced or eliminated in favor of incentives to private housing developers, such as tax credits, accelerated depreciation, mortgage interest deductions and mortgage revenue bonds. Tax credits, depreciation writeoffs and interest expenses are available without regard to the characteristics or location of the persons for whom housing is made available or the purpose of that housing. In 1984, tax expenditures due to mortgage interest deductions on vacation homes totaled $1.2 billion. In cases where targeting is attempted, such as mortgage revenue bonds, it is often ineffective. Projects financed with revenue bonds need only reserve 20% of their units for persons with low- and moderate-incomes; and much of the interest subsidy inherent in revenue bonds is dissipated in the form of "windfall" after-tax returns to high-income holders of such bonds.

(3) The impact of the President's proposal for tax reform on cities has yet to be explored in its entirety. No definitive answer has been found as to what the impact of the _whole_ of the proposal, its direct and indirect effects, will be on the _whole_ of our urban communities -- their economies, their neighborhoods, their institutions, people, projects and industries. What is clear is that tax reform, if adopted as proposed, is likley to have significant effects on:

(i) the flow of capital to institutions, projects, industries important to the economic growth and cultural vitality of cities;

(ii) the housing stock, both single and multifamily, of cities;

(iii) the general welfare of the types of people who live in cities; and

(iv) the flow of resources to local government operations and capital investment programs.

Following are some examples of the potential impact of the President's tax reform proposals.

Flow of Capital to Institutions/Projects/Corporations Important to Cities

Proposed tax reform would -- both in the short term and over long term -- mean a sharp end to the major commercial/real-estate oriented development that is transforming older cities. Cities are not on equal footing when it comes to development. Development costs are higher in urban locations. The elimination of investment tax credits, historic and rehabilitation credits and tax exempt private purpose revenue bonds will eliminate many of the tools cities have used to write down development costs. The extension of "at risk" rules to real estate and the imposition of interest limits on the deductibility of expense will deter limited partnerships from taking on larger real estate projects. Stretching out depreciation expense, together with eliminating credits, will mean that investors will have to rely more, and more quickly, on cash flow and will be willing to take fewer risks with respect to that cash flow. This will favor high growth over low growth areas and will discourage investment in marginal areas.

Tax reform proposals are generally good news for the service and retail-oriented corporations that make up more and more of the economy of cities. Unfortunately, the elimination of credits and dilution of depreciation shelter may only increase the economic pressures on many of the older, traditional, capital intensive industries now employing large blocks of the laborers in cities.

These are industries that cannot simply "pick up and leave" and must cope with changes through further reductions.

Cities are exciting places to live in large part because they are centers for the visual and performing arts. Charitable giving will be relatively more expensive post tax reform because of the reduction in marginal individual tax rates. This shouldn't affect the majority of givers. But for that wealthy minority which accounts for a large portion of the available funding -- including, by the way, corporations who support foundation activities -- this could make a difference. A local study suggests that there has been a drop in giving in the Twin Cities since the most recent reductions in individual federal income tax rates.

Housing Stock

The President's proposals are likely to result in a dramatic increase in the cost of rental housing. The same elimination of development incentives (loss of credits, revenue bond financing, depreciation stretch-out and recapture) will dampen new multi-family construction. Projects that do get built will need to generate increased cash flow through higher rents. Projects that don't get built will, in time, exacerbate the undersupply of rental housing in most cities which, in turn, will lead to higher rents.

The loss of single family mortgage revenue bonds will make it harder for cities to make housing affordable for low and moderate income groups.

General Welfare of City Residents

The impact of the President's proposal on the overall welfare of people who live in the city is perhaps hardest to gauge because the impact of Treasury II varies across income groups, and because the many secondary effects are difficult to predict. In general, however, it can be said that the proposals are most beneficial for "traditional" families with one wage earner. People like that live in cities. But cities also attract single-parent families, two income families where both spouses must or choose to work, and a preponderance of young single people.

Cities also have within their borders high concentrations of low and moderate income families. Here, the President's proposals show some promise. From most analysis, it appears that many segments of the poor will fare better under the proposed reforms than under current law largely due to increases in the zero bracket amount and to changes in the earned income tax credit.

These direct impacts, however, could be offset -- entirely or in part -- by secondary effects, such as increases in the rents these families are required to pay; or pressures to reduce government social spending (from taxpayers for whom the cost of government programs has increased as a result of the loss of deductability of their local taxes); or declines in the resources of foundations who fund social programs.

Municipal Operations and Capital Spending

Perhaps the most explicit and predictable changes on the City of Saint Paul resulting from TRSY II will be changes in the way the city functions as a municipal corporation. The City has all kinds of reasons to borrow capital, construct infrastructure, provide services and respond to the needs of its citizens. The elimination of state and local deductibility will increase the burden on local taxpayers, reduce the progressivity of state and local taxes, and lead to pressure to cut spending for local government services. The elimination of deductibility will exaggerate the disparity between the cost of public services in high tax states and cities and low tax states and cities. An extension of this argument would suggest that this disparity would become a more important factor in the state-to-state or city-to-city location decision of corporations and individuals . . . This may have urban and regional growth policy consequences.

The consensus is that eliminating private purpose bonds and shelter-oriented investments will reduce the supply of tax-advantaged securities and will, as a result, reduce the interest rates local governments pay on borrowing for their capital investment programs. The results of tax reform are likely to be more complex. There will be a decrease in the supply of public debt. But eliminating the ability of banks to deduct interest expense associated with their purchases of tax-exempt bonds will also remove banks as a purchaser of tax-exempt debt and narrow the market for government debt. Individuals who now buy the vast majority of tax-exempt bonds will become virtually the sole source of capital for local governments. And, as a result of the drop in individual marginal tax rates, tax exempt bonds will be much less attractive to these individuals than they are today. Corporations, too, will have less reason to invest in tax-exempt bonds.

Beyond this, the economic incentive for privatization of municipal capital ventures -- which has been a promising source of new capital in recent years -- is likely to disappear.

(4) Early in his first term of office, President Reagan outlined his "New Federalism" proposal which called for a "swap" of responsibilities and programs between the federal and state and local government. The major components of this "New Federalism" proposal were 1) The return of 40 federal programs to state and local governments, 2) Federal Monetary policies to encourage continued economic growth and decrease reliance on government assistance, and 3) Establishment of urban enterprise zones. While Congressional reaction to the President's "New Federalism" was largely negative and few of the President's proposed changes appeared in new legislation, the President continues to advocate the use of local resources to meet state and local needs. The consolidation of several categorical programs into Federal Block Grants to the States was accompanied by large reductions in the amount of absolute federal dollars expended for the consolidated programs. This reduction forced state and local recipients of the Block Grants to make up the shortfall in costs of existing services and be solely responsible for financing any new or increased services. Minnesota, Saint Paul, and other communities assumed these new responsibilities and raised state and local taxes to meet the service needs.

July 3, 1985
St. Paul, Minnesota

Testimony for
United States Senate Subcommitte
on
Intergovernmental Relations

by

Jean Olson, President
Minnesota School Boards Association

Mr. Chairman, members of the committee, I am Jean Olson, an elected member of the Duluth School Board and president of the Minnesota School Boards Association. Thank you for the opportunity to testify as to the current state of education in Minnesota and the impact on education of proposed federal tax reforms.

Minnesota enjoys a national reputation for excellence in education. Our governors, legislators, and citizens have a tradition of strong commitment to public K - 12 education. Taxes and education were the top priorities of the 1985 legislative session. In spite of a significant tax cut, the next biennium will see an increase in spending for K - 12 education, with 24 % of the state budget allocated for education. Citizen polls give schools high grades and indicate a willingness to spend money for education.

In the early 1970's, Minnesota established a school finance formula designed to reduce reliance on local property taxes, based on the belief that a child's education should not depend on the wealth of a local district. This increased reliance on state funding has also made schools vulnerable to fluctuations in the state economy. For example, in 1981 a shortfall in state revenues was passed onto local school districts. Duluth, that year, in an effort to cut six million dollars from our budget (14% of the total), closed eight schools and laid off 200 employees.

These cuts were necessary in spite of continuing efforts to cut expenditures and to operate more efficiently. State law demands that our meetings and records are open to the public. We are prohibited from deficit spending. Levy limits are set by the state; local districts may, with voter approval, adopt levies in excess of those limits. Voter approval is also necessary for majoy capital expenditures requiring bonding.

Increased costs and increased demands for services indicate a continued need for revenue. We are understandably concerned that proposed tax reforms be evaluated to assess their impact on the ability of the state and local districts to provide stable and adequate funding of education. We are especially concerned about the proposal to eliminate the deduction of state and local taxes on federal income tax returns.

Clearly this proposal has greater impact on high-tax states. It is important to remember, however, that high taxes pay for a high level of services. Minnesotans, who are willing to support good schools, maintain good roads, and to care for their neighbors, should not be unfairly penalized by the federal government.

While the loss of deductibility would not directly affect revenues available for education, we are concerned that in the long run revenues could be affected. First, taxpayer pressure at the state level could impact state aids to education. If the loss of state aid were cushioned by increases in local levies, we could see further retreat to the funding of education based on wealth of local districts. Because voters must give referendum approval to excess levies for bonding for major capital improvements, it is very likely that voter frustrations with taxes in general would be expressed by refusing to approve school referenda.

Our concern, then, is for the indirect effect that the loss of deductibility could have on education revenue. A well-educated public is critical to our economy and essential to our democratic form of government. If public education is to be the responsibility of state and local government, then we must retain the authority to obtain the revenue to provide good schools. While tax reform proposals need to be evaluated on the basis of their overall impact on the economy and on the taxpayer, we ask that you continue to carefully assess the long term impact on state and local government.

Jean Olson

2029 East Superior
Duluth, Minnesota 55812

Testimony by Jay Kiedrowski
Commissioner of Finance, State of Minnesota
to the
U.S. Senate Subcommittee on Intergovernmental Relations
Senator Durenberger, Chairman
Wednesday July 3, 1985
Room 15, Minnesota State Capitol

The topic before the subcommitte this morning is the implications of President Reagan's proposed tax reform on Minnesota's economy and taxpayers. Before I address that I believe it is important that I comment on a far greater and more urgent need of the taxpayers and economy of Minnesota -- a reduction in the federal deficit.

Large federal budget deficits place upward pressure on nominal and real interest rates. Higher interest rates strengthen the dollar. With a strong dollar imports increase and the pace of exports decreases. The farm and manufacturing sectors are being hit hard by the high dollar with some permanent erosion of national and international market shares occuring.

Minnesota, whose economy tends to mirror the national economy, is beginning to suffer from this lopsided recovery the nation is experiencing. The farm and mining sectors of our economy are in recession. Even the computer industry in Minnesota is slowing, reflecting the inability to sell products to a stagnant manufacturing sector. Minnesota and its taxpayers need a substantial reduction in the federal deficit if we are to have full, sustained economic growth.

Discussions about tax reform should in no way divert attention from efforts to substantially lower the federal deficit and give greater momentum to the recovery. And tax reform should not add to the problem.

The administration's own estimates indicate that the President's proposal would not be revenue neutral, but is a revenue lower which will add billions to the deficit in future years. Any tax reform should at a minimum be revenue neutral. Also, many economists now believe that the anticipation, ot at least the uncertainty, of a number of the proposed tax changes, is reducing investment and may be slowing the recovery. Reform discussions should occur in the context of effort to reduce the deficit.

SUMMARY: PRESIDENT'S PROPOSAL

The President's proposal is a major tax reform. Reforming a complex income tax system is extremely difficult. Complexity was created by a multitude of special constituencies, some large and some small, who obtained changes in the tax law which accommodate particular activities. In reforming a complex law, it is easy for the public interest and the interest of the average taxpayer to be lost as special constituencies fighting to protect each separate special provision. Those of us in Minnesota who have just gone through such a fight in reforming our state income tax law are especially sensitive to looking at the general interest of the whole as well as the special interests of individual constituencies.

President Reagan's tax reform proposal has a number of benefits for the country as a whole. The first is that it promises long run economic growth through a broader base and lower rates of taxation. In these times of increased international competition and large U.S. trade deficits, the national economy must be reinvigorated. An improved economy is in the best interest of all the individual constitutencies affected by tax reform. Minnesota needs a strong national economy.

The President's proposal also attempts to make the tax system more fair and simple. Attempts to achieve these goals are seldom applauded, but are still very important in making the tax system understandable and acceptable.

While the President's proposal would move the tax system in the right direction, it does create some legitimate problems -- especially in the transitional period. Foremost of these from Minnesota's point of view is the elimination of deductability of state and local taxes. Deductability is an important link in the intergovernmental system. Alternatives to full elimination should be considered. Jim Solem, the Executive Director of the Minnesota Housing Finance Agency, will address another problem in the changes in tax-exempt bonding.

The following is a more detailed review of the impacts the President's tax reform proposal will have on the:

- National Economy
- State Government Revenues
- Federal Tax Liability for Minnesotans
- Intergovernmental Aspects
- Alternate Tax Changes

THE NATIONAL ECONOMY

In the long run, the proposal promises increased economic growth and increase national wealth.

The key changes proposed in the federal tax law are (1) a significant lowering of marginal tax rates through a broader base, (2) an increase in the individual deduction, (3) the elimination of many tax shelters, (4) simplification of the law, and (5) a shift of business taxes to achieve greater neutrality in tax law.

(1) The significant lowering of marginal tax rates through base broadening should increase the incentive (or reduce the penalty) for productive work or investment. Secondarily, it should also transfer economic activity from the illegal underground economy to the legal economy by reducing the advantage of avoiding taxes.

(2) The increase of the individual deduction to $2,000 will remove a large number of low income workers and their families from income taxation. It will increase the incentive of low income individuals, particularly those with children, to work for wages and allow working low income families greater disposal income.

(3) The elimination of many tax shelters and the reduction of marginal tax rates should improve the real economic return on total capital investment. A market economy over the long run maximizes wealth creation by rewarding more productive investment and penalizing less productive investment. Tax shelters (and high marginal tax rates which differentially effect returns on different types of investments) distort the market mechanism by rewarding investment in less productive areas.

(4) Simplification of the law will increase the real productivity of the economy. Currently, the complexity of the tax law requires that a great deal of time and energy be diverted from productive activity to the calculation and filling out of complex forms. Further, the complexity of the law rewards diversion of time and energy from productive work to figuring tax minimization strategies, shifting behavior to conform to a tax minimization strategies, and documenting actions with potential tax minimization effects.

(5) The shift of business taxes and tax incentives to achieve greater neutrality in the tax law should increase the productivity of business investment. The current federal tax law has incentives to invest in long-lived capital goods (buildings and heavy machinery). These incentives distort the capital market by shifting investment from the most productive use. These incentives encourage investment in the weakest sector of the economy (heavy manufacturing) and encourage over investment

in commercial real estate. Consequently, these incentives divert capital from high technology and service industries, the most dynamic and growing segments of the economy.

Minnesota's economy resembles very closely that of the nation as a whole. The only significant difference is larger trade and agricultural sectors in Minnesota than for the U.S. economy. As a general rule, policies which increase the productivity of the U.S. economy will also improve Minnesota's economy. For that reason, **in general and in the long run the Reagan tax reform proposal should generate more economic growth in Minnesota.**

MINNESOTA STATE GOVERNMENT REVENUES

Chiefly due to the new Minnesota income tax law, the direct impact on state government revenue will be minor. The Reagan tax proposal will reduce federal income taxes on most taxpayers. Consequently, those Minneosta taxpayers who deduct federal income taxes on their state income tax will have a smaller deduction and will pay slightly higher state taxes. Under the new Minnesota state income tax law about one-third of taxpayers will deduct federal taxes. If the Reagan plan were adopted, about half of these will find it advantageous to shift to the state tax table without federal deductibility. **The net change in state taxes due to lower federal taxes will be an increase in state revenue of about $10 million a year.**

The Reagan plan provides for a broader federal tax base. If, as one would expect, Minnesota adopts the broader federal tax base as the base for the state income tax, then Minnesota state tax rates could be reduced. **Roughly, Minnesota state tax rates could be cut by 7.5% in a revenue neutral accommodation for the broader federal tax base and the reduced level of federal taxes.** (Alternately, retaining existing Minnesota state tax rates with the new federal tax base and reduced federal taxes would produce about $220 million a year in increased state government revenue.)

FEDERAL TAX LIABILITY OF MINNESOTANS

Federal individual income taxes on individuals in Minnesota will fall by $450 to $500 million under the Reagan plan according to estimates made by Minnesota's Department of Revenue. This is a reduction of $155 to $172 per taxpayer. Taxes on an average one-earner married couple ($35,000) would drop about 7.1% or $245. Taxes on a two-earner couple with the same income would not change significantly. A single taxpayer of average income ($15,000) would get a tax cut of about 11% or $179. A minority of taxpayers would have slighly higher taxes.

The reduction in federal taxes on individuals in Minnesota is not proportionately as great as the reduction for the nation as a whole. Minnesota's state and local taxes are above average, and the removal of these taxes as a deduction will disadvantage

Minnesota taxpayers more than those in a state with average or below average state and local taxes. If Minnesota state and local taxes were average, than the reduction in federal individual income taxes would be about $100 million greater. Thus, in a certain sense **one can say that Minnesota will pay a $100 million tax penalty by the removal of the deductibility of state and local taxes.**

This penalty will be paid, however, only by a minority (40% to 45%) of Minnesota taxpayers.

Those 55% to 60% of Minnesotans who do not itemize their federal taxes will enjoy a reduction in federal taxes which will be exactly the same as that of nonitemizers located in any state.

The 40% to 45% who do itemize will have less than average reduction in federal taxes because of the elimination of deductibility. As noted, a one earner family with $35,000 income in Minnesota will receive about a 7.1% or $245 cut in federal taxes. However, if Minnesota taxes were average, then the reduction would be 13.1% or $484 cut. Thus, compared to the average, the reduction in tax in Minnesota would be 49% or $239 less than the average for a family of that income.

INTERGOVERNMENTAL ASPECTS

The Reagan plan by abolishing the deductibility of state and local taxes on the federal income tax will increase the net cost and citizen resistance to increased state and local taxes. Deductibility provides for a partial federal absorption of any tax increased imposed by state and local government. A local property tax increase, for example, is presently deductible on both the state income tax and the federal income tax. For someone in the highest marginal tax bracket under both tax systems, state and federal governments will pay for more than half of the tax increase. If such deductibility were removed, then the net cost of a local property tax increase to such a taxpayer would double.

In a federal system of government the lowest level of government able to carryout a function of government is generally the most appropriate level to do so. The ability of the lowest level of government to carryout its functions is enhanced by its ability to raise sufficient revenue. In our view, under a federal system higher governments should accommodate revenue raising by lower governments by providing for deductibility or credits for taxes paid to those lower governments.

Minnesota state government just reformed its state income tax, and broadened the tax base and lowered its rates by restricting deductibility of federal income taxes. This, of course, is reducing the deductibility of the taxes of a higher level of government. Minnesota did not adopt, and indeed never considered, broadening its tax base and lowering rates by eliminating the deductibility of the taxes of lower units of government. Minnesota retains full deductibility of local property taxes. We believe that Minnesota's state income tax system fully conforms to a tax structure compatible with a federal system of government.

In broadening the base of the federal income tax, we believe that the Reagan plan has relied on elimination of the state and local deduction to too great of an extent. Indeed, it appears that over half of the base broadening comes through this elimination. In view of the limited extent of base broadening proposed in other areas (the mild limit on interest deductions and the limited inclusion of fringe benefits), we do not think that the total abolition of the state and local tax deduction is appropriate.

We think that it would be desirable to maintain in whole or in part the deductibility of state and local taxes in the federal income tax law.

ALTERNATIVE TAX CHANGES

We are prepared to support other revenue raising measures which will enable the state and local tax deduction to be retained while still significantly lowering marginal rates or reducing the deficit. In particular we would call your attention to energy taxes. If we have learned one thing from the energy crisis, it is that the market mechanism works in the area of energy. Energy consumption is price elastic. Increased energy taxes will in the short run raise revenue to reduce the deficit or to improve the tax reform program. In the long run, higher energy taxes will encourage energy conservation, reduce energy waste, and strengthen the energy independence of our economy.

Senator DURENBERGER. For our third panel, we will hear from several representatives of the major industries in Minnesota who will address the impact of the tax proposal and the effect on our State's economy.

The first is Rollie Lake, who has been president of Communicating for Agriculture, Fergus Falls, MN, since 1982.

Prior to this, he spent 15 years of vocational agriculture instruction and 20 years as senior vice president of the First National Bank of Fergus Falls.

Rollie, we welcome you here, as we always have in Washington, for your insight into agriculture financing issues, and thank you for being part of this hearing.

TESTIMONY OF ROLLIE LAKE, PRESIDENT, COMMUNICATING FOR AGRICULTURE, FERGUS FALLS, MN; GORDON DONHOWE, EXECUTIVE VICE PRESIDENT, FAIRVIEW COMMUNITY HOSPITALS; ARCHIE D. CHELSETH, MANAGER, PUBLIC AFFAIRS, POTLATCH CORP.; AL E. FRANCE, PRESIDENT, LAKE SUPERIOR INDUSTRIAL BUREAU; AND JOHN G. HORNER, GENERAL COUNSEL, MINNESOTA MULTI-HOUSING COUNCIL

Mr. LAKE. Thank you, Senator. My name is Rollie Lake and I'm president of Communicating for Agriculture. I'm pleased to have this opportunity to appear before the Senate Subcommittee on Inter-Governmental Relations and discuss the impact of the President's tax reform plan on agriculture.

The administration's proposal to simplify our current tax is certainly one of the major issues now under consideration by the Congress and it is a key concern of agriculture here in the State of Minnesota.

Any tax proposal made or enacted by the Federal Government automatically has a great impact on agriculture and it is, therefore, essential the members of the agriculture community have the opportunity to express their opinions about how they believe they would fair under the tax reform before it is put in place. We commend you for providing this opportunity to us.

Today I would like to discuss two elements of the administration's tax proposal; industrial development bond financing and agriculture tax shelters.

The tax exempt status of industrial development bonds, IDB's, used to fund many State agriculture programs will end on December 31, 1985, if President Reagan's Tax Simplification Act is approved.

Such action would gut, do away with the IDB-based agriculture loan programs operating in Illinois, Iowa, Nebraska, Louisiana, Montana, and many other States, a total of 22 States.

AGGIE bonds have been used by States since 1980. Most of the 22 State programs were established between 1981 and 1984 and we estimate that more than 3,000 young farmers have benefited from the AGGIE bond use. In Illinois alone 1,200 farmers have begun their operations with the help of these tax exempt bonds.

Nationally $247 million of IDB's have been used for agriculture purposes to fund State operated agriculture loan programs.

Industrial development bond financing is one of the most unique ways that currently exists to provide lower cost interest loans to the young farmers, for the lower net worth beginning farmer there is simply no other places that they can turn.

Farmer's Home Administration is not able to meet the needs of these beginning farmers. The industrial development bonds fill the need and at a very reasonable cost to the Government. If industrial development bond financing is eliminated and not replaced by an alternative financing program to assist our Nation's qualified beginning farmers we would lose a whole generation of farmers and this today is a serious problem.

The use of industrial development bond financing offers no exposure to the Federal Government. The way the programs are currently being operated in many of the States, there are no Federal or State guarantees standing behind the loans. Many people in the Federal Government have argued that the use of tax exempt industrial development bonds is a drain on the Federal Treasury.

However, the recent study of the agriculture banks participating in the Illinois and Iowa program indicates that the loss to the Federal trade is minimal. Banks are not in a high enough tax bracket to need a tax exempt bond in their loan portfolio. The reason they are participating in the program is the opportunity to provide a lower cost loan to a customer they could otherwise not serve.

Overall agriculture has been a modest and responsible user of tax exempt financing.

I conclude my discussion on the use of industrial development bond financing use in agriculture by urging that agriculture continue to have the access of this source of financing beyond the President's proposal to eliminate IDB's in 1985 and beyond existing subsections in 1986.

The overall tax system to agriculture is a tremendous concern. According to agriculture economist Breimyer of the University of Missouri, there is no chance of preserving family farming if tax rules are not changed. There is no point in even trying unless the tax matter is addressed and corrected. The present tax system is not logical because it hurts the family farm. As agriculture has become a tax shelter it has become less profitable. The Tax Code has increased supplies and hurt the prices of commodities. It has concentrated the ownership, it has increased land prices and made it harder for newcomers to enter, it has caused the growth of very large and very small farming operations. It has reduced the efficiency and changed the management practices.

Again, to quote Dr. Harold Breimyer, the family farm is on the path of oblivion, it is headed that way for reasons having little to do with the record of its performance. It is being killed by two national policies, one is the tight money policy and the other is the income Tax Code. The biggest pressures against family farm agriculture is the Tax Code. The sheltered investment in agriculture has the competitive advantage over the unsheltered investment. The tax shelters and agriculture have become more and more attractive to outside investors, it has become more and more difficult for family farmers to compete.

It's difficult for family farmers whose primary source of income is from farming, to compete with these investors who are not interested in making a farm product. The C.A. recognizes that tax reforms are difficult to achieve, the reasons are complex and the outcome of the reforms uncertain. Oftentimes the road to reform is paved with good intentions but is uncertain and may have unexpected consequences. For these reasons the C.A. believes that tax shelters should be limited to family farmers and not available to outside investors.

The C.A. proposes that the benefits be targeted to commercial family farmers with annual sales between $40,000 and $200,000. It is the C.A.'s firm belief that any program in agriculture today must be targeted to the family farmer because they have been the backbone of our agriculture system and the most dependable source of food the world has ever known.

If the administration tax proposal were to be enacted it would place family farmers at a more competitive disadvantage than they now are experiencing. If the Tax Code remains unchanged and the present program is enacted all investment agriculture investors will come from the outside, thereby eliminating family farmers and the family commercial farm.

I would just like to make a few points so far as the President's tax plan is concerned. Eliminating the investment credit on an industry that has high investment in the first place, the family farm, it would only add to the agriculture cost. Changing capital gains from 40 to 50 percent again would add to the cost of operating that farm. Elimination of the elimination of the breeding stock so far as a capital gains concern, we're claiming that 20 to 25 percent of the livestock income comes from breeding stock.

Depreciation changes, going from 3 years on up, is going to add to the cost. Change in the fertilizer expense from the year purchased to the year benefited is going to add to the expense of an already high industry. Water and soil conservation expense going from the year that work is done to the year of value again is going to add to the cost of maintaining the family farm and eliminating the income averaging whereby you are in a business where 1 year can be very good and 1 year can be very bad will also add to the cost and, of course, that's already been stated to you that State and local taxes are becoming nondeductible, which will also add to the cost.

Now, I want to thank you for this opportunity, Senator, and if you have any questions I will be happy to answer them.

Senator **Durenberger**. Rollie, thank you very much for your testimony.

Our next witness is Gordon Donhowe, currently chief executive vice president and chief operating officer of Fairview Community Hospital and former commissioner of finance for the State of Minnesota. Welcome.

Mr. **Donhowe**. The institution I represent operates 1,543 acute hospital beds. We are a nonprofit hospital group.

That statement establishes, in part, where I stand simply by where I sit.

In my prior incarnation, as commissioner of finance for the State of Minnesota, I was an ardent advocate of tax reform and radical simplification of the State income tax. It would seem inconsistent to do other than embrace the objective of tax reform at the Federal level.

The stated objective of the President's proposal for tax neutrality is laudatory. I believe the phrase "creating a level playing field" has been used by Treasury officials.

The purpose of my testimony this morning is to suggest that what may appear to be tax neutrality may have unintended consequences for health care simply by reason of how the industry has historically been organized. The division of the players between for profit and not-for-profit creates the issue. As matters currently stand, we conclude that there is approximate equivalence in the net effect on Fairview should we be for profit as opposed to nonprofit. Based upon Treasury II we believe not-for-profit providers would see distinct advantages in becoming for-profit organizations.

Both the tax system and medicare/welfare reimbursement systems serve to lower the net cost of debt. Since capital costs are still reimbursed by Medicare and welfare on a retrospective, actual cost basis, the impact on debt cost is directly analogous to tax deductibility. What this means then, is that the investor owned sector receives a double subsidy of debt cost versus a single subsidy in the nonprofit sector.

Doing our own calculations and comparing three large chains—AMI, HCA, and Humana we conclude that net debt cost based upon gross marginal debt cost in today's market, would be between 2 and 2½ percent higher for ourselves than for-profit competitors.

Similarly, the investor owned organizations currently receive a return on equity capital from the Medicare Program whereas not-for-profits do not. This practice is based on the unusual assumption that not-for-profits do not need a return on equity capital to remain viable.

Obviously, one key advantage that the not-for-profits have is avoidance of taxation. The question then becomes one of determining how the relative advantages/disadvantages net out. While it is dangerous to generalize from a single case, it would appear that we would have a rough equivalence currently with what it would be as a for-profit.

The tax obligation pickup, assuming our rate was approximately 45 percent—similar to a not-for-profit—would be essentially offset by our ability to obtain a return on equity throughout Medicare reimbursements and the additional debt subsidy by deductibility. Loss of tax exempt financing would be the only way for the tax plan to tip the scale in favor of for-profits and it would be approximately equivalent to 20 percent of our net earnings.

Our position is not, repeat, not to advocate the preservation of tax exempt financing for hospitals as the only solution to "keeping a level playing field" as between for-profit and nonprofit enterprises. Inasmuch as Treasury II, in effect, modifies health care policy it is altogether possible that equity can be restored by the reimbursement policies for Medicare. For example, an allowable return on equity for Fairview similar—identical, as a matter of fact, to for-profits, approximates the give up on tax exempt financing.

Keeping or not keeping a level playing field is not a minor health care policy issue. Not-for-profits generate general fund balances in only one way—by accumulated earnings. By definition we cannot sell new equity. By obligation we reinvest our earnings in the community and in the business.

A strong nonprofit sector of health care providers should remain a desirable objective of public policy. The experience in the Twin Cities is instructive. We are regarded as one of the more competitive marketplaces in the country. We are dominated by not-for-profit players. There is persuasive evidence that well managed not-for-profits have equivalent, if not lower, cost structures than the for-profits. And, more importantly, have lower prices whether they be better managed or not.

We are a not-for-profit organization by choice—we would like to remain so.

Tipping the playing field in favor of the for-profits would suggest several forecastable changes. First, the large publicly owned chains will become dramatically larger as the merger trend accelerates. Second, nonprofit hospitals will follow the lead of our colleagues, the HMO's, by creating for-profit management firms, merging to obtain scale, and then selling shares to the public. It has not gone unnoticed that 4 of the 10 highest paid executives in the country last year were employed by for-profit health care corporations.

To sum up:

We support the objectives of creating a "level playing field" for all players.

There are unintended consequences of Treasury II that advantage for-profit health care organizations over their nonprofit competitors.

The answer need not be to preserve tax exempt financing for nonprofits, but to equalize reimbursement policies under Medicare.

There is a public policy advantage in having nonprofit competitors in the marketplace.

We simply ask to retain a level playing field after Treasury II.

Senator DURENBERGER. Thanks, Gordon. Our third speaker on the panel is Mr. Archie Chelseth. Archie is manager of public affairs for Potlatch Corp.

Mr. CHELSETH. Thank you, Senator. For the record I am Archie Chelseth, Minnesota public affairs manager for Potlatch Corp., a diversified forest products company with manufacturing facilities and timber holdings in Arkansas, Idaho, and Minnesota.

I am here today on behalf of Minnesota Forest Industries, Inc., an eight-member industry association of the major pulp and paper and wood products firms operating in the State. Our members include The Blandin Companies, Boise Cascade Corp, Champion International Corp., Consolidated Papers, Inc., Hedstrom Lumber Co., Potlatch Corp, Rajala Timber Co., and Superwood Corp. I am also representing the forest Industries Committee on Timber Valuation and Taxation, a national organization whose supporters include timberland owners of all sizes from all timber producing regions of the country.

Senator DURENBERGER. Are you going to introduce your assistant there, Mr. Rajala?

Mr. CHELSETH. I was about to do that. With me this morning is Mr. Jack Rajala, president of the Rajala Timber Co. in Deer River. Jack is chairman of the Minnesota Forest Industries and also serves as a Minnesota chapter president of the national committee and if I get in deepwater, Senator, Jack will help me out.

Mr. Chairman, we do appreciate your invitation to share with the subcommittee this morning our industry's views on some key provisions of the administration's tax reform plan as submitted to the Congress in late May of this year.

While we want to be supportive of legislative efforts to simplify and improve the Nation's Tax Code, we also want to help ensure that the effects of proposed changes are well understood before Congress takes final action.

Certain of the administration's proposals will affect all industries—especially capital-intensive industries—but there are three proposals in the President's plan which we believe will uniquely and adversely impact upon the future economic health and viability of the forest products industry in this country.

Three issues our industry will specifically address today are the administration's proposals to repeal timber capital gains taxation, require capitalization of currently deductible timber management expenses, and repeal special reforestation incentives for smaller woodlot owners.

Let me speak briefly to the critical importance of each of these issues:

Although the President's plan would retain capital gain treatment for some taxpayers, it would repeal the specific timber capital gain provisions of the U.S. Tax Code. As a result, gains from timber cut by an owner or sold pursuant to a cutting contract with a retained economic interest would no longer be taxed at capital gain rates. Instead, they would be taxed at ordinary income rates, which could be as much as 35 percent for individuals and 33 percent for corporations. As compared with today's maximum rate of 20 percent, and 28 percent, respectively.

Under the President's plan, timber that is used in a trade or business would be denied capital gains treatment no matter how it was sold.

However, timber that is not used in a trade or business could continue to be eligible for capital gains treatment if it was held in a manner classifying the taxpayer as a casual or passive investor.

The administration's proposals for timber, in effect, would reward timber owners with the lower capital gain rate if they do not manage their timber and sell it outright, while timber owners who apply modern timber management practices, including sustained yield, would be penalized with the much higher ordinary income tax rates.

We, as an industry, are deeply concerned about the proposed repeal, because we believe it is an unsound public policy that will discourage timber regeneration, inhibit intensified forest management and encourage the liquidation of present timber investment in the United States.

We believe the present treatment of timber capital gains should be continued:

First, because since it's adoption in 1944, the capital gains provision has proven to be an effective tool in strengthening our timber management practices and increasing the productive output of our Nation's forests.

Second, despite the quest for equity and fairness, the administration's plan discriminates against those timber owners who manage their timber for better growth. The proposals, if adopted, would actually serve as an incentive for poor forestry practices, something we believe our Nation can ill-afford at a time when all available forecasts, public and private, project significant increases in timber demand to meet growing consumer needs.

Third, given 40-, 50-, and even 60-year rotations, timber growing is a long-term investment subject to long-term risks. We believe Congress ought to continue a tax policy that encourages substantial new and increased investment in timber growth.

And, finally, we believe the Congress ought to keep faith with timber owners throughout the country who have planted and maintained their forests since 1944 in anticipation of fair tax treatment upon harvest.

If I might skip a couple of issues, Senator, in the interest of time, they are included in my printed statement and just narrowly focus the discussion for a few moments to the State of Minnesota.

The Legislative Commission on Minnesota Resources, in its 1980 timber resource study, found that between 1962 and 1977 there was an 11-percent reduction in Minnesota's commercial forest land base, a loss of nearly 114,000 acres per year. And, while we presently have 13.6 million acres of commercial forest area, estimates of future forest losses range from 49,000 to 73,000 acres per year.

Quite simply, that means that forest land owners in Minnesota must be prepared to more intensively manage each and every productive acre in the years ahead to sustain the future fiber needs of our State's third largest industry well into the 21st century.

Nearly 25 percent of our Minnesota forest land is under the stewardship of 120,000 private forest owners. The policy issues we have talked about today touch the lives and livelihoods of thousands of families throughout Minnesota.

Since the late 1970's, the industry in Minnesota has invested more than $600 million in new plants, plant expansions and various modernization projects. Those investments were no doubt tied to our existing forest resources, as well as to future expectations of available wood fiber.

Moreover, the Minnesota Legislature in the 1980's has responded positively to this new investment and the further potential growth of our industry through its support of intensified forest management on State and county lands.

In our view, now is not the time to undermine this momentum by sudden and unwarranted shifts in Federal tax policy that will dampen interest in timber-growing and increase the likelihood of critical shortages in the supply of our industry's basic raw material.

Thank you, very much.

Senator DURENBERGER. Thank you.

Speaking next will be Mr. Al France, president of the Lake Superior Industrial Bureau. Al, welcome.

Mr. FRANCE. Thank you, Senator, and thank you for asking us to offer our views on the Federal tax reform proposals that are advanced by the President.

As you know, I'm representing a group of iron mining and taconite companies in the State of Minnesota.

Certainly, I do not need to dwell on the decline of our State mining industry and the economic downturn and misery which it has caused. You are well aware of these problems. Because of inherent economics and the industrial policies of other countries, the only feasible market for Minnesota iron ore is the U.S. domestic steel industry, particularly in the Great Lakes area. Also, because of inherent economics and partly because of restrictive trade practices and industrial policies of foreign nations, the only feasible market for domestically produced steel is the metals manufacturing and other capital intensive sectors in the national economy. Consequently the economic health of the iron ore industry in Minnesota is directly affected by Federal policies, including tax policies, which affect the domestic steel industry and domestic metals manufacturing as a whole.

Since 1981, the strong dollar and the business recession, compounded by a surge of subsidized foreign steel imports, have depressed domestic steel markets, with significantly adverse effects on Minnesota iron ore mining. Reduced mine operations, temporary mine closings, and now a permanent mine closing have become all too familiar. And, of course, most unfortunate of all, the steel import situation and decline of U.S. manufacturing have reduced significantly the number of well paying jobs that the iron ore mines could offer to Minnesota men and women.

While we do support generally, the goals of the President's Tax Reform Program; fairness, simplicity, and economic growth, we believe careful examination is critical since we are deeply concerned about some major thrusts of the President's proposals against capital intensive companies, including mining companies. And we hope that through your examination, a better reform proposal than any which have been advanced so far can be developed.

The extraordinary merchandise trade deficits of recent years, which have been accompanied by the progressive loss to foreign countries of manufacturing jobs and activities previously conducted in this country, are well documented. Additionally, steel companies have proven in a variety of government forums that subsidized and dumped imports have been the major contributing factor in the operating losses, reduced operations and capital shortfalls of domestic integrated steel companies.

In view of these factors, we simply do not understand why the administration's tax proposals tend to penalize this stressed segment of the U.S. economy.

The tables showing tax receipts by source which accompany the administration's proposals dramatically illustrate, in the aggregate, our concerns. Over the 1986-90 period, three capital cost recovery proposals—the adjustment of depreciation schedules, the repeal of the investment tax credit, and the recapture of rate differentials on accelerated depreciation—are expected to produce tax increases of $222 billion from corporations, an amount significantly greater than the $156 billion in corporate rate cut benefits for both. These totals are stated before considering the proposals penalizing iron ore mining in particular, such as repeal of percentage depletion and capital gains treatment for iron ore royalties and the deferment of reclamation costs to the point of completion or closure. In Minnesota as you may know, some of these costs are concurrent with the cost of mining.

Particularily, we do not believe the investment tax credit should be repealed when under present law, capital recovery incentives are about in the middle compared with those of other principal trading nations and these nations' tax systems frequently "tip the international playing field," and that's an illusion, by rebating part of their domestic taxes when products are exported, while imposing taxes on imports.

If a massive shift of funds away from investment in business machinery were enacted by the tax law, we fear it would cause more steel consumers to choose to manufacture out of the United States, or to pursue noncapital intensive endeavors, a further loss of domestic steel customers.

We must note that Congress has already stated in the Trade and Tariff Act of 1984 that steel import relief will be ineffective—unless the industry engages in serious efforts substantially to modernize and improve its international competitiveness. The act also requires major companies in the steel industry to reinvest substantially all their net cash flow from steel operations. So Congress has recognized the necessity for modernization expenditures in the domestic steel and iron ore industries.

For capital-starved and loss-ridden steel and iron ore companies, which frequently can only gain advantage of equipment investment incentives in the Tax Code through reduced rentals on leased equipment, the cost penalties will be exaggerated as equipment lessors seek to maintain their economic rates of return. As a consequence, some major modernization projects in the basic steel and iron industry that will be built under current tax law simply would not be built under proposed laws because they would fall below the hurdle rate regarding economic return.

Iron ore mining has capital formation incentives unique to mining which are threatened by the administration's proposals. Percentage depletion and capital gains treatment for iron ore royalties are all provisions which encourage both new and modernization investment in iron ore mining by recognizing the special risks involved in mining. It is not timely to remove provisions which stimulate modernization investment in iron ore mining, particularly with the developing threat of increased volumes of imported iron ore.

We believe it would be harmful for Minnesota iron ore mining and for the United States if our Government were to adopt public policies which hasten the atrophy of our Nation's manufacturing and mining sectors and which accelerate the deterioration of our merchandise trade and balance of payments.

As a final note, and this has been said before and it certainly reflects our view, that the most critical issue today in Government finance, and perhaps in international trade considering the effect of the strong dollar, is the reduction and eventual elimination of the huge Federal deficit. With this in mind, we strongly urge that tax reform adopted should not be enacted which will worsen these deficits.

Senator DURENBERGER. Thank you. Our last witness is Jack Horner, who is general counsel for Minnesota Multi-Housing Association.

Jack, glad to have you here today. As I indicated earlier, everyone's statement will be made part of the record. You may summarize, if you would, in 5 minutes.

Mr. HORNER. Thank you, Mr. Chairman. I will do that. In fact, I will simply summarize some of the points as they are listed in more detail in my report.

Mr. Chairman, I appreciate your inviting me to share some of the concerns that we have about rental housing in these next few minutes.

In Minnesota 28 percent of all dwellings are renter occupied and in the Twin City area, one-third of the dwellings are rental. Renter households tend to be those people who are either younger or older than the average household, more often are female headed families, minorities and the poor.

The renter's average income is much lower than that of home owners and, in fact, according to the Minnesota Department of Energy and Economic Development, some 80 percent of all tenants are lower and moderate income households who have little choice in the housing market.

I'm going to mention just a couple of these concerns, but I want you to know that I am aware that you share our concerns. We want to again offer whatever services our members or I can be.

First, we are concerned about the proposed change in the depreciation schedule for rental housing that would increase the current 18-year depreciation schedule to 28 years. The plan that goes with the proposed depreciation schedule would not allow component depreciation nor accelerated depreciation. This proposal would not only undo the current 18 years ACRS, but would go much further to the point where it would actually treat rental housing worse than pre-1981 when ACRS and other provisions were enacted.

Due to component depreciation the effective depreciation schedule of rental housing was in the range of 18 to 22 years, certainly not 28 years as is being considered.

Another item of concern is the deductible limit of $5,000 of interest paid for so-called passive investments over the amount of passive investment income. The administration's tax bill would bring all consumer debt, with the exception of the principal residence, into the $5,000 maximum. More importantly for this discussion, it would define a limited partner in a rental housing project, a housing investor, as a passive investor. This would be a very serious detriment to the raising of capital needed to build rental housing.

Third, we strongly oppose the application of the at risk rule to rental housing. Under this provision, accumulative deductions over the life of a project that a taxpayer could take would be limited to the amount that he had at risk. In general this is the money that he has invested or debt for which he is personally liable. This provision would have a very serious negative effect on the ability to raise capital for rental housing. It means that in order to finance rental housing one would have to find investors who are either willing to place themselves at risk by increasing their own investment or liability or accept significantly reduced tax shelter, thus reducing the sheltering effect and strongly increasing the cost of building and operating rental housing.

Fourth, we are concerned about the provision requiring the recapture of depreciation for the years 1980 to 1986. We are not going to go into the details of any of this other than to say that under this provision, apartment owners and other real estate owners could find themselves in the situation of having to pay very large amounts of taxes for depreciation recapture on buildings they have not sold yet. So, they could have a very large net tax that is not accompanied by a sale of the building. This additional amount of money that would have to be spent in taxes would certainly encourage owners to try to recover these funds through increased rents and other operating incomes.

Finally, we are strongly opposed to prohibiting the use of tax exempt bonds for the construction of rental housing. In Minnesota we use a great deal of tax exempt bonds and other government assistance. In Minnesota you virtually cannot build, in most cases, rental housing without some form of government assistance, generally tax exempt bonds. The available rents—the rents that people can afford simply will not pay for the construction and operation of rental housing.

In summary, we feel that it's highly probable that any tax benefit that renters would achieve through the income tax reform would be far more than offset by increased rents. We have heard economists stating that 20 to 40 to 44 percent increases in rents would be necessary. For example, a typical tenant earning $15,000 would, according to the figures that we have, benefit $100 to $200 per year because of the tax reform. But, an extremely modest rent increase, say 10 percent on a typical $350 apartment, is $35 per month or over $400 per year. This is a $200 to $300 net loss per year and that would just be the first year or two.

Well, I could go on, but I see my time is up so I won't. Mr. Chairman, these are somber thoughts, but we do feel that the rental housing industry is in a very precarious position, and we feel that the tax proposal being enacted would make it very difficult to provide needed housing. We have and do provide housing that people can afford; $300 rent could very easily and most likely would become $500, $600, $700 rents in the years following an enactment of one or more of these provisions. This is something that would be very difficult for us to deal with, Mr. Chairman. Thank you.

Senator DURENBERGER. Jack, while you are standing there, let me just ask you if you have any notion about where we are going in this country in terms of shelters. Obviously, for several reasons, we have used inflation to raise the average price of family shelter in America to something in the neighborhood of $86,000. I can understand why nobody can move into that kind of market without some kind of subsidy. But before you arrived here, I made a crack about the fact that there ought to be some fairness in the tax system. It bothers me a little bit to know that George Bush made more money last year than I did, but I'm in the 44-percent Federal and 54-percent national tax bracket overall, and he is in the 12½-percent bracket because he bought into some kind of apartment building, or something, down in Houston. And the community is $22 billion overbuilt.

How long do we go on? I'm sure that everyone of your clients has a legitimate reason for using subsidies to meet very specific demand; but now that we have raised the price offering so high, isn't there some more efficient way than these tax subsidies to meet the demand for shelters in this country? Why don't we just pay people *X* number of dollars, for example? Do you have any notions on that?

Mr. HORNER. Mr. Chairman, I discern a considerable general import to your question and at least two specific things. First of all, as to overbuilding, we would not object to provisions that would tend to reduce that possibility. That's just inherent in a free market.

In Minneapolis-St. Paul Twin City area, however, vacancy rates the last few years are, in fact, becoming rather low. The latest figure for St. Paul is 3.5 percent vacancy, which is a rather low vacancy. These are rental housing figures—Minneapolis is 5.4 percent, the metropolitan area, according to the Metropolitan Council is 4.2 percent vacancy rate. So, I don't think we are in danger here, at least now, of overbuilding.

As to how to finance rental housing, we feel that the various sheltering aspects of rental housing perform very, very well. First, they help in keeping rents low; rents are significantly lower than the consumer price index. Second, they, with a minimum of involvement and cost to government compared to the more massive housing programs, the more massive direct payment subsidy programs, actually are less expensive and require less involvement of the government to produce the housing.

Senator DURENBERGER. Have you any idea what it would cost, without tax subsidies, to rent a one-bedroom apartment in downtown Minneapolis or St. Paul?

Mr. HORNER. Without any tax subsidy, including without the ability to use tax exempt bonds, for example?

Senator DURENBERGER. Right.

Mr. HORNER. Statistics would show rent would go up from anywhere from $200 to $300 per month. You can get a one-bedroom apartment now, for example in the vicinity of $350 to $450. This is not a luxury unit but kind of a typical apartment. To build without any of these tax subsidies, you would easily, as a minimum, have to be thinking in terms of $700 to $800 rent.

Senator DURENBERGER. OK. Thank you.

One of the issues that cuts across a variety of industries, of course, is that of minimum corporate tax. Since we discovered all the companies whose titles start with "General"—like General Electric and General Dynamics—which do not pay any taxes, we haven't convinced people that payroll tax is a tax because employers contribute to it. I'm sure there are groups still developing out here, someplace, in support of a minimum corporate tax. Look at the national resource industries that are in depression, and might be for some time in this country—agriculture, mining, and forestry, at least the construction side of forest products. What are your views on enactment of a minimum corporate tax? You would certainly have to face that issue. Anybody want to address that?

Mr. FRANCE. I really do not want to address it but I have heard it discussed, certainly, and it is of concern particularly to the steel companies who, over the past 3 years, have losses that are approaching $8 billion, I believe, and to think of a minimum corporate tax applying to losses of that magnitude is a bit of a contradiction in itself. But I understand the frustration of people when corporations are not paying any tax. Perhaps a real—I shouldn't do this but maybe the larger question should be, should corporations pay any taxes at all, since it's a passthrough tax, really, fundamentally. I think that needs addressing as well. It is the larger philosophical question involved here.

But, a minimum tax on a loss does not seem to make a lot of sense. If there are profits and they are being sheltered, maybe then there could be a formula developed where there would be taxes.

Senator **Durenberger**. Anyone else desire to comment on that? Gus, while you are here, I wonder if you would give me your perspective from your last two jobs on tax-exempt bond financing, particularly on the difficulties that we would undoubtedly face in distinguishing between private and public type bonds. And where the decisionmaking takes place. Right now, there doesn't seem to be anybody who really gets to make a decision on the government level; you are sort of forced to make decisions.

Mr. **Donhowe**. Well, Senator, I would really be speaking for myself. I am one of those who oppose what I consider the excessive use of tax-exempt financing. The marketplace is telling us that right now. It's primarily because of a very narrow difference between those who have overdone that dramatically, oversupplying the purchasing capability of taxes and products by a bunch. So, there is no doubt we have got to cut it back and we have got to cut it back drastically or there would not be any significant advantage to the people for the privilege. I think the idea of the public purpose and private purpose makes good sense.

Senator **Durenberger**. Talking about houses?

Mr. **Donhowe**. Yes, we think there are other ways, as I said in my testimony, which are equitable and equivalent to other competitors, the problem is you can say just about everybody that uses it if you take it away and do awful things to us what's happened. However, we have gotten everybody hooked. I don't think there is anything substantially wrong with a tax bill as proposed.

[Prepared statements of Messrs. Lake, Donhowe, Chelseth, France, and Horner follow:]

Prepared Statement of Rollie Lake

CA INC
COMMUNICATING FOR AGRICULTURE

Law Office Building
P O Box 677
Fergus Falls, Minnesota 56537 9990

Phone (218) 739 3241

Immediate Release

For Information:
Bill Adams (218)739-3241
Jeff Smedsrud (612)854-8118

Reagan Tax Reform Plan Threatens State Ag Loan Programs

The tax-free status of industrial development bonds (IDBs), used to fund many state ag programs, will end on Dec. 31, 1985 if President Reagan's Tax Simplification Act is approved.

Such action would gut IDB-based agricultural loan programs operating in Illinois, Iowa, Nebraska, Louisiana, Montana, Michigan, Indiana, Ohio, Colorado and 13 other states.

Communicating for Agriculture, a Minnesota-based national group that led efforts to create many of the state loan programs, is working to change the Reagan plan so that the bonds--known as "aggie bonds"--will retain their tax-free status.

CA Vice President Bill Adams, a leading authority on aggie bonds, estimates more than 3,000 young farmers have benefitted from the aggie bonds. "In Illinois alone, 1,200 farmers have begun their operations with help from aggie bonds." Nationally, $247 million of aggie bonds have been issued to fund state-operated agriculture loan programs, most of which are earmarked for beginning farmers.

Aggie bonds have been used by states since 1980. Most of the 22 state programs were established between 1981 and 1984.

A spokesman for the U.S. Treasury Department told CA that the Tax Simplification Ace would "repeal that tax exemption for all industrial development bonds not for municipal use."

Explaining the rationale, he noted, "use of bonds for other than municipal purposes has grown and it's extremely expensive for the federal government. Even though some of the reasons are commendable, like offering low-interest loans to young farmers, the Treasury Department has taken the position that they should be used for revenue, rather than social and economic reasons."

However, many state officials who work with aggie bonds say their use---in the long run---actually brings money into the federal treasury.

Bill Greiner, Director of the Iowa Family Farm Development Authority, the oldest continuously-operating state IDB agricultural loan agency, explains, "They say IDBs take money out of the federal treasury, but what nobody ever says is how much money they put back in (revenue from) new jobs. There's got to be some consideration to that side of the ledger."

Don Schaner, Director of the Michigan Family Farm Development Authority, agrees. He maintains IDB-based agricultural loans do not result in any "overall revenue Loss" to the federal government.

And, Ron Bailey, Director of the Illinois program and President of the National Council on Agricultural Finance Programs, says, "I don't think people realize what effect IDBs have had on agriculture. I think everyone wants 'tax simplification' but I don't think everyone is aware of the price we will have to pay."

Larry Strange, Director of the Texas program, says he finds it difficult to understand "Why the government seems so intent on removing all support for agriculture when agriculture is in the midst of the worst crisis since the dust bowl."

In Ohio, Deputy Agriculture Director Tony Logan commented, "It's sadly ironic that just as Ohio's (IDB) program is getting off the ground, President Reagan is pulling the rug out from under it. It would seem equitable that Congress and the Administration would at least allow the use of industrial development bonds for agricultural purposes so farmers could benefit the way other businesses have over the past decade."

In explaining how farmers benefit from aggie bonds, banker Eugene Meli of McClean County Bank in Bloomington, Illinois estimates "Such loans have reduced the interest rate 4½ to 5 percent.

That's very important today with a tight cash flow. One client saved $72 per year, per acre in interest costs."

"Today, interest is one of the biggest cost factors. If you can reduce it 3 or 4 percent, it is of prime importance," says Megli.

Two young farmers who benefitted from aggie bonds are Craig Alexander of Danvers, Illinois and Dan Schick of Clinton, Illinois.

Alexander, 35, raises corn and soybeans. He is purchasing 40 acres with a 10-year $100,000 loan through the Illinois program, and says he will pay at least three percent less in interest than he would have at the local Federal Land Bank or from conventional sources. "That kind of savings can mean the difference between making it go and backsliding."

Schick, 37, says he "probably wouldn't be raising hogs today if it wasn't for the (IDB) program." He built a new gestation building and remodeled a finishing building and a pig nursery with a $50,000 loan.

If the IDB programs are ended, state officials say the long-term effects will be dramatic.

"For the lower net worth person, there's just not a lot of places he can turn", said Greiner. "If something isn't done to assist these young people, we could lose a generation of farmers, and that's kind of serious."

CA and the National Council of State Agricultural Finance Programs are working to retain use of the aggie bond programs. Both groups plan to testify before the House Ways and Means Committee and the Senate Finance Committee.

Concerned persons are urged to contact CA for additional information. The telephone number is (218) 739-3241.

CA is a national rural advocacy group with 40,000 dues-paying members. It is best known for its work to assist beginning farmers, and most recently, for its modified debt recovery program.

6/28/85

PREPARED STATEMENT BY GORDON M. DONHOWE OF FAIRVIEW COMMUNITY HOSPITALS

SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
JULY 3, 1985

My name is Gus Donhowe, Executive Vice President of Fairview Community Hospitals. The institution I represent operates 1,543 acute hospital beds. We are a non-profit hospital group.

That statement establishes, in part, where I stand simply by where I sit. But I should equally acknowledge and disclose that I am in my first week as a member of FCH management. That puts the matter in the best light possible--to be specific, this is the morning of my third day!

In my prior incarnation, as Commissioner of Finance for the State of Minnesota, I was an ardent advocate of tax reform and radical simplification of the state income tax. It would seem inconsistent to do other than embrace the objective of tax reform at the federal level. There is an arguable position that would support the contrary position. But I am here to support federal tax reform.

The stated objective of the President's proposal for tax neutrality is laudatory. I believe the phrase "creating a level playing field" has been used by Treasury officials.

The purpose of my testimony this morning is to suggest that what may appear to be tax neutrality may have unintended consequences for health care simply by reason of how the industry has historically been organized. The division of the players between "for profit" and "non-profit" creates the issue. As matters currently stand, we conclude that there is approximate equivalence in the net effect on Fairview should we be for profit as opposed to non-profit. Based upon Treasury II we believe non-profit providers would see distinct advantages in becoming for-profit organizations.

Our very quick calculations are as follows:

Subsidy of Debt Cost

Both the tax system and Medicare/Welfare reimbursement systems serve to lower the net cost of debt. Since capital costs are still reimbursed by Medicare and Welfare on a retrospective, actual cost basis, the impact on debt cost is directly analogous to tax deductibility. What this means then, is that the investor owned sector receives a double subsidy of debt cost versus a single subsidy in the non-profit sector. The following schedule suggests that the lower tax exempt rate is not sufficient to offset the double subsidy.

	For Profit				Non-Profit
	AMI	HCA	Humana	Average	FCH
Gross Marginal Debt Cost	12.1%	11.1%	13.0%	12.1%	10.0%
Tax Rate	45.8	41.0	41.8	42.9	-
Reimbursement Rate	45.0	45.0	48.0	46.0	38.0
Net Debt Cost	3.6	3.6	3.9	3.7	6.2

Medicare is proposing to roll capital costs into the prospective rate at some time within the next two years, thus eliminating the reimbursement subsidy to a large degree. The relative advantage of the investor owned sector would remain, however, since this change would impact both sectors.

Return on Equity Capital

Investor owned organizations currently receive a return on equity capital from the Medicare program whereas non-profits do not. This practice is based on the unusual assumption that non-profits do not need a return on equity capital to remain viable. There is some feeling that this advantage may be eliminated at some point, but it continues to exist at this time.

Obviously, one key advantage that the non-profits have is avoidance of taxation. The question then becomes one of determining how the relative advantages/disadvantages net out. While it is dangerous to generalize from a single case, it would appear that FCH is at a rough equivalence currently with what it would be as a for-profit. The impact of for-profit status on our income statement could be approximated as follows for fiscal 1984:

Tax Liability	
Assumed Tax Rate	45%
1984 Earnings	$7.1 million
.45 x 7.1 =	-$3.2 million
Return on Equity	
Average Hospital General Fund Balance	$45 million
Medicare Reimbursement %	33%
Allowable Return	11.5%
.115 x .33 x $45 =	+$1.7 million
Additional Debt Subsidy	
Assumed Net Debt Cost Differential	2.0%
Outstanding Debt	$75 million
.02 x $75 million =	+$1.5 million

An elimination of tax exempt financing would tip the scale in favor of for-profit status and is approximated as follows:

Assumed gross differential in taxable and tax exempt rates	3.0%
Cost reimbursement %	38%
Net additional cost of debt (1 - .38) 3.0=	1.9%
1.9% x $75 million =	$1.4 million

Our position is not to advocate the preservation of tax exempt financing for hospitals as the only solution to "keeping a level playing field" as between for-profit and non-profit enterprises. In as much as Treasury II, in effect, modifies health care policy it is altogether possible that equity can, in large part, be restored by the reimbursement policies for Medicare. For example, an allowable return on equity for Fairview approximates the give up on tax exempt financing.

Keeping or not keeping a level playing field is not a minor health care policy issue. Non-profits generate general fund balances in only one way--by accumulated earnings. By definition we cannot sell new equity. By obligation we reinvest such earnings in the community and in the business.

A strong non-profit sector of health care providers should remain a desirable objective of public health care policy. The experience in the Twin Cities is instructive. This community is generally regarded as one of the more competitive marketplaces for health care. It is dominated by non-profit players. There is persuasive evidence that well managed non-profits have equivalent, if not lower, cost structures than the for-profits. And, more importantly, have lower prices whether they be better managed or not.

It has been argued that the incentive of tax exempt financing has contributed to the excess capacity in the hospital industry. Beyond that, the continuing access to such tax exempt financing is further alleged to compound the problem of excess capacity. This argument really boils down to margins, however you get there. We would argue that the causes of the excess capacity are far more complex than tax exemption. What will fix excess capacity is competition and the radical reorganization of the industry that the marketplace is both allowing and encouraging to happen.

We are a non-profit organization by choice--we would like to remain so. Being non-profit fits our mission and is compatible with our church related roots. We allege that we are good at what we do. From the available evidence we are among the lowest cost providers in this marketplace. Our ability to generate competitive earnings is the key to both quality and being a low cost provider.

Tipping the playing field in favor of the for-profits would suggest several forcastable changes. First, the large publicly owned chains will become dramatically larger as the merger trend accelerates. Second, non-profit hospitals will follow the lead of our colleagues, the HMOs, by creating for-profit management firms, merging to obtain scale, and then selling shares to the public. It has not gone unnoticed that four of the ten highest paid executives in the country last year were employed by for-profit health care corporations.

To sum up -

- We support the objectives of creating a "level playing field" for all players.
- There are unintended consequences of Treasury II that advantage for-profit health care organizations over their non-profit competitors.
- The answer need not be to preserve tax exempt financing for non-profits, but to equalize reimbursement policies under Medicare.
- There is a public policy advantage in having non-profit competitors in the marketplace.
- We simply ask to retain a level playing field after Treasury II.

Statement by
Archie D. Chelseth
Potlatch Corporation

U.S. Senate Committee on Governmental Affairs
Subcommittee on Intergovernmental Relations

July 3, 1985
9:00 a.m. - Room 15, State Capitol
St. Paul, Minnesota

Mr. Chairman, Members of the Subcommittee:

I am Archie Chelseth, Minnesota public affairs manager for Potlatch Corporation, a diversified forest products company with manufacturing facilities and timber holdings in Arkansas, Idaho and Minnesota. Here in Minnesota Potlatch has pulp and paper operations in Cloquet and Brainerd, and wood products plants in Cloquet, Bemidji and Cook. As an industrial tree farmer and wood converter, we have timber holdings in 17 forested counties in northern Minnesota.

I am here today on behalf of Minnesota Forest Industries, Inc., an 8-member industry association of the major pulp and paper and wood products firms operating in the state. Our members include The Blandin Companies, Boise Cascade Corp., Champion International Corp., Consolidated Papers, Inc., Hedstrom Lumber Co., Potlatch Corp., Rajala Timber Co. and Superwood Corp. I am also representing the Forest Industries Committee on Timber Valuation and Taxation, a national organization whose supporters include timberland owners of all sizes from all timber producing regions of the country -- from small tract owners and tree farmers to the largest of the integrated forest products companies. With me this morning is Mr. Jack Rajala, president of the Rajala Timber Co. in Deer River, and chairman of the Minnesota Chapter of the FICTVT.

Mr. Chairman, we do appreciate your invitation to share with the subcommittee this morning our industry's views on some key provisions of the administration's tax reform plan as submitted to the Congress in late May of this year.

While we want to be supportive of legislative efforts to simplify and improve the nation's tax code, we also want to help ensure that the effects of proposed changes are well understood before Congress takes final action.

Certain of the administration's proposals will affect all industries--especially capital-intensive industries--but there are three proposals in the President's plan which we believe will uniquely and adversely impact upon the future economic health and viability of the forest products industry in this country.

Three issues our industry will specifically address today are the administration's proposals to 1) repeal timber capital gains taxation, 2) require capitalization of currently deductible timber management expenses, and 3) repeal special reforestation incentives for smaller woodlot owners.

Let me speak briefly to the critical importance of each of these issues:

TIMBER CAPITAL GAINS:

Although the President's plan would retain capital gain treatment for some taxpayers, it would repeal the specific timber capital gain provisions of the U.S. tax code. As a result, gains from timber cut by an owner or sold pursuant to a cutting contract with a retained economic interest would no longer be taxed at capital gain rates. Instead, they would be taxed at ordinary income rates, which could be as much as 35 percent for individuals and 33 percent for corporations. This contrasts with today's code provisions where individuals are now subject to a tax on their timber capital gains at a maximum rate of 20 percent, and corporations are now taxed on such gains at 28 percent.

The proposals would also modify the general capital gain provisions applying to outright or lump-sum sales. There would be two tests to qualify for capital gains. First, as in current law, the taxpayer must not be a dealer (instead he must be viewed as a casual or passive investor). Second, he must not hold his timber for use in a trade or business.

Timber that is used in a trade or business would be denied capital gains treatment no matter how it was sold. For example, even a one-time outright sale of timber by one who regularly managed his timber stand for better yield could be denied capital gain treatment.

However, timber that is _not_ used in a trade or business could continue to be eligible for capital gains treatment if it was held in a manner classifying the taxpayer as a casual or passive investor (_i.e._, a non-"dealer"). For example, a one-time outright sale of timber held _not_ as a part of regular business but as a long-term investment with no management activity could receive capital gains treatment.

The proposal provides that the taxpayer's basis in timber held for business purposes--and thus denied capital gains treatment--would be indexed for inflation. The new proposal would not provide an adjustment for past inflation, as did the November Treasury proposal.

The administration's capital gains proposals for timber, in effect, would reward timber owners with the lower capital gain rate if they _do not_ manage their timber and sell it outright, while timber owners who apply modern timber management practices, including sustained yield, would be penalized with the much higher ordinary income tax rates.

We, as an industry, are deeply concerned about the proposed repeal, because we believe it is an unsound public policy that will discourage timber regeneration, inhibit intensified forest management and encourage the liquidation of present timber investment in the United States.

In short, there are four major reasons why we believe the present treatment of timber capital gains should be continued:

1) First adopted in 1944, the capital gains provision has proven to be an effective tool in strengthening our timber management practices and increasing the productive output of our nation's forests.
2) Despite the quest for equity and fairness, the administration's plan discriminates against those timber owners who manage their timber for better growth. The proposals, if adopted, would actually serve as an incentive for poor forestry practices, something our nation can ill-afford at a time when all available forecasts, public and private, project significant increases in timber demand to meet growing consumer needs. The U.S. Forest Service, for example, is estimating that domestic demand for paper and wood products may indeed double by the year 2030.
3) Given 40, 50 and even 60 year rotations, timber growing is a long-term investment subject to long-term risks. We believe Congress ought to continue a tax policy that encourages substantial new and increased investment in timber growing at a time when shortfalls between timber supply and demand are becoming more and more likely in the United States. In short, an acre not planted results in timber volume foregone forever.
4) And, finally, we believe the Congress ought to keep faith with timber owners throughout the country who have planted and maintained their forests since 1944 in anticipation of fair tax treatment upon harvest.

TIMBER MANAGEMENT EXPENSES, INTEREST AND PROPERTY TAXES:

The administration's proposal would require the capitalization of timber management expenses, including overhead, property taxes, and interest paid or incurred during the entire time in which the timber is standing prior to harvest. This is in contrast to present law which permits the deduction of timber management expenses after the timber is established and the deduction of property taxes and interest regardless of when the timber is established. To the extent that the proposal requires the capitalization of these costs, they too would be indexed for inflation.

Timber owners are entitled to be treated the same as the owners of all other assets; the cost of acquiring or creating an asset is capitalized while the cost of managing the asset is deducted currently. Specifically, planting and reforestation costs are capitalized while fire and insect control, maintenance and silvicultural costs, interest and property taxes are deducted currently.

Requiring capitalization of management and carrying costs would be inconsistent with accepted accounting standards. The proposed capitalization of timber management and carrying costs is inconsistent with the financial statements of all companies within the industry audited by various public accountants. it would require a different treatment for timber than for virtually all other forms of capital investment.

We believe this proposal is extremely complex and inequitable. To require owners to capitalize management and carrying costs over 40 years and to allocate these costs to particular tracts and species in no way simplifies the administration of the tax code. Adjusting these amounts annually for inflation and allocating the adjustments to particular tracts and species further compounds the complexity that would be required.

Again, Mr. Chairman, we believe this proposal also takes us down the wrong road at a time when we ought to be working to restore the economic health of our nation's forest products industry.

REFORESTATION INCENTIVES FOR SMALLER OWNERS:

Under current law timber owners are permitted deductions over 84 months and a 10% tax credit for up to $10,000 of reforestation expenses annually.

These reforestation incentives are providing small and medium-sized landowners with additional economic encouragement to replant their property after harvest. The administration's plan would mistakenly repeal these incentives, again threatening to lessen the productive output of our nation's commercial forestland base.

In closing, Mr. Chairman, permit me to narrow the focus of this discussion to the State of Minnesota for just a few moments.

The Legislative Commission on Minnesota Resources, in its 1980 timber resource study, found that between 1962 and 1977 there was an 11 percent reduction in Minnesota's commercial foestland base, a loss of nearly 114,000 acres per year. And, while we presently have 13.6 million acres of commercial forest area, estimates of future forest losses range from 49,000 to 73,000 acres per year.

Quite simply, that means that forestland owners in Minnesota must be prepared to more intensively manage each and every productive acre in the years ahead. In our judgment, federal and state policies--including tax policies--ought to encourage the management commitment and economic investment necessary to sustain the future fiber needs of our state's third largest industry well into the 21st century.

Today, the renewable resources of our public and private forests in Minnesota are the basis of a $2.85 billion a year industry... an industry that provides full and part-time jobs for nearly 49,000 Minnesotans. In addition, nearly 25% of our Minnesota forestland is under the stewardship of 120,000 private forest owners. Thus, the policy issues we have talked about today touch the lives and livelihoods of thousands of families throughout Minnesota.

Since the late 1970s, the industry in Minnesota has invested more than $600 million in new plants, plant expansions and various modernization projects. Those investments were no doubt tied to our existing forest resources, as well as to future expectations of available wood fiber.

Moreover, the Minnesota Legislature in the 1980s has responded positively to this new investment and the further potential growth of our industry through its support of intensified forest management on state and county lands, as well as increased technical assistance to non-industrial private forestland owners through our Department of Natural Resources.

Now is not the time to undermine this momentum by sudden and unwarranted shifts in federal tax policy that will dampen interest in timber-growing and increase the likelihood of critical shortages in the supply of our industry's basic raw material.

Mr. Chairman, thank you for the opportunity to appear this morning on these important topics. Mr. Rajala and I would be happy to respond to any questions you might have.

Statement of Alfred E. France
President, Lake Superior Industrial Bureau
Before
Hearing of Senator David Durenberger
July 3, 1985

I am Al France, President of the Lake Superior Industrial Bureau, an association of iron mining and taconite companies in Northern Minnesota. Thank you for asking us to offer our views on the federal tax reform proposals that have been advanced by President Reagan's administration.

Certainly, I do not need to dwell on the decline of our State mining industry and the economic downturn and misery which it has caused. You are well aware of these problems. Because of inherent economics and the industrial policies of other countries, the only feasible market for Minnesota iron ore is the United States domestic steel industry, particularly in the Great Lakes area. Also, because of inherent economics and partly because of restrictive trade practices and industrial policies of foreign nations, the only feasible market for domestically produced steel is the metals manufacturing and other capital intensive sectors in the national economy. Consequently the economic health of the iron ore industry in Minnesota is directly affected by federal policies, including tax policies, which affect the domestic steel industry and domestic metals manufacturing as a whole.

Since 1981, the strong dollar and the business recession, compounded by a surge of subsidized foreign steel imports, have depressed domestic steel markets, with significantly adverse effects on Minnesota iron ore mining. Reduced mine operations, temporary mine closings, and now a permanent mine closing have become all too familar. And, of course, most unfortunate of all, the steel import situation and decline of U.S. manufacturing have reduced significantly the number of well paying jobs that the iron ore mines could offer to Minnesota men and women.

While we support the general goals of the President's tax reform program; fairness, simplicity and economic growth, we believe careful examination is critical since we are deeply concerned about some major thrusts of the President's proposals against capital intensive companies, including mining companies. We hope that through your examination, a better reform proposal than any which have been advanced so far can be developed.

The extraordinary merchandise trade deficits of recent years, which have been accompanied by the progressive loss to foreign countries of manufacturing jobs and activities previously conducted in this country, are well documented. Additionally, steel companies have proven in a variety of government forums that subsidized and "dumped" imports have been the major contributing factor in the operating losses, reduced operations and capital shortfalls of domestic integrated steel companies.

In view of these factors, we simply do not understand why the Administration's tax proposals tend to penalize this stressed segment of the U.S. economy.

The tables showing tax receipts by source which accompany the Administration's proposals dramatically illustrate, in the aggregate, our concerns. Over the 1986-1990 period, three capital cost recovery proposals - the adjustment of depreciation schedules, the repeal of the investment tax credit, and the recapture of rate differentials on accelerated depreciation - are expected to produce tax increases of $222 billion from corporations, an amount significantly greater than the $156 billion in corporate rate cut benefits. (These totals are stated before considering the proposals penalizing iron ore mining in particular, such as repeal of percentage depletion and capital gains treatment for iron ore royalties and the deferment of reclamation costs to the point of completion or closure. In Minnesota some of these costs are concurrent with the cost of mining.)

Particularily, we do not believe the investment tax credit should be repealed when under present law, capital recovery incentives are about in the middle compared with those of other principal trading nations and these nation's tax systems frequently "tip the international playing field" by rebating part of their domestic taxes when products are exported, while imposing taxes on imports.

If a massive shift of funds away from investment in business machinery were enacted by the tax law, we fear it would cause more steel consumers to choose to manufacture out of the United States, or to pursue non-capital intensive endeavors, a further loss of domestic steel customers. Further declines in domestic steel customers will mean further reductions in iron ore production, with continuing devastating effects upon the economic health of the people in Northern Minnesota.

Turning to the direct effects of the tax proposals on iron ore and steel companies modernization efforts, I first note that Congress has already stated in the Trade and Tariff Act of 1984 that "steel import relief will be ineffective -- unless the industry engages in serious efforts substantially to modernize and improve its international competitiveness." The Act also requires major companies in the steel industry to reinvest "substantially all their net cash flow" from steel operations. Congress has recognized the necessity for modernization expenditures in the domestic steel and iron ore industries.

For capital-starved and loss-ridden steel and iron ore companies, which frequently can only gain advantage of equipment investment incentives in the tax code through reduced rentals on leased equipment, the cost penalties will be exaggerated as equipment lessors seek to maintain their economic rates of return. As a consequence, some major modernization projects in the basic steel and iron industry that will be built under current tax law simply would not be built under proposed laws because they would fall below the "hurdle rate" regarding economic return, or they otherwise simply cannot be financed.

Iron ore mining has capital formation incentives unique to mining which are threatened by the Administration's proposals. Percentage depletion and capital gains treatment for iron ore royalties are all provisions which encourage both new and modernization investment in iron ore mining by recognizing the special risks involved in mining. It is not timely to remove provisions which stimulate modernization investment in iron ore mining, particularly with the developing threat of increased volumes of imported iron ore.

We believe it would be harmful for Minnesota iron ore mining and for the United States if our government were to adopt public policies which hasten the atrophy of our nation's manufacturing and mining sectors and which accelerate the deterioration of our merchandise trade and balance of payments.

Because of these strong concerns, we again commend your commitment to a thorough evaluative process. From this process, we believe tax legislation can emerge which will not damage our mining or manufacturing industries, and will better balance the requests for rate relief and capital investment incentives.

As a final note, I offer our belief that the most critical issue today in government finance (and perhaps in international trade considering the effect of the strong dollar) is the reduction and eventual elimination of the huge federal deficit. With this in mind, I strongly urge that tax reform measures should not be enacted which will worsen these deficits.

Because of the brief nature of this statement, we would be pleased if you wish to submit more detailed comments later. And, of ccurse, we would appreciate the opportunity to discuss these matters further with you as these matters continue in the legislative process.

Thank You.

TESTIMONY OF JOHN G. HORNER, GENERAL COUNSEL
MINNESOTA MULTI HOUSING ASSOCIATION
3100 WEST LAKE STREET
MINNEAPOLIS, MN 55416 612/927-8602
PRESENTED TO THE SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
DAVID DURENBERGER, CHAIRMAN
SAINT PAUL, MINNESOTA
JULY 3, 1985

My name is Jack Horner. I am the General Counsel of the Minnesota Multi Housing Association. The Minnesota Multi Housing Association is a statewide organization representing owners, builders, and managers of rental housing, condominiums and other forms of multi-dwelling housing.

Mr. Chairman and Members of the Subcommittee, I appreciate your inviting me to share some of our concerns with you during these next few minutes. In Minnesota, 28 percent of all homes are renter-occupied. In the Twin City Metropolitan area, 1/3 of all households are rental. Renter households tend to be those people who are either younger or older than the average household, and more often are female headed households, minorities, and the poor. Renters' average income is much lower than that of homeowners. In fact, according to the Minnesota Department of Energy and Economic Development, "some 80 percent of all tenants are low and moderate income households who have little choice in the housing market."

We have some very serious concerns regarding the effect of current tax proposals on rental housing supply, maintenance, and affordability.

We urge you to consider the effects on rental housing of some of the provisions of the current bill being proposed by the Administration. I have necessarily limited my remarks to a few selected sections of this proposal; however, the members of my Association and I are available in whatever way we might be of service.

First, we are concerned about the proposed change in the depreciation schedule for rental housing that would increase the current 18 year depreciation schedule to 28 years, permit a maximum of 4 percent per year depreciation deduction and adjust the basis of the property annually by the inflation rate. The proposed depreciation schedule would not allow component depreciation nor accelerated depreciation. This proposal would not only undo the current 18 percent ACRS depreciation, but would go much further, to the point where rental housing would be treated worse even than before 1981, when ACRS and other tax provisions were enacted. Due to component depreciation, prior to 1981 the average effective depreciation schedule for rental housing was probably 18 to 22 percent.

Another item of serious concern is the deductible limit of $5,000 of interest borrowed for so-called passive investments over the amount of passive investment income. The Administration's Tax Bill would bring all consumer debt (except for the principal residence) into the $5,000 maximum, and would define a limited partner in a rental housing project as a passive investor. This would be a serious detriment to raising the capital necessary to produce needed rental housing.

Thirdly, we strongly oppose the application of "at risk" rules to rental housing. Under this provision, the cumulative losses over the life of a project that a taxpayer could deduct would be limited to the amount he had at risk. This, in general, is the money that he has invested in the project plus debt for which he is personally liable. This provision would have a most serious, negative effect on the ability to raise needed capital for rental housing. Limiting the available deduction to only the amounts at risk means that in order to finance rental housing one must find investors who are either willing to place themselves at risk or accept significantly reduced tax shelter. Reducing the tax sheltering effect of the investment increases the cost of building and operating the rental housing. This provision is an attempt to cure a problem that largely does not exist in rental housing. As a general rule, the use of non-recourse debt in real estate transactions has not been abusive.

Fourth, we are also very concerned about the provision requiring recapture of depreciation for the years 1980 to 1986. I need not go into the details of this provision other than to say that requiring owners of real estate that had been depreciated to pay taxes whether or not they have sold the property would be a great hardship on many property owners. Payment of potentially very large amounts of tax when the building has not been sold will certainly increase the pressure to recover the money spent through increased rents.

Finally, we are strongly opposed to prohibiting the use of tax-exempt bonds for the construction of rental housing. In Minnesota, it is common knowledge that it is generally very difficult if not virtually impossible in most cases to build apartments without some form of government assistance, typically tax-exempt bonds. The rents that are possible to obtain, and which people can afford, are simply not high enough to pay for the building and operation of needed new rental housing without the assistance derived through the use of these bonds. This method of financing rental housing has perhaps produced the greatest amount of rental housing at the least cost or involvement to government of any rental housing program.

Professor William Brueggeman of Southern Methodist University, has been retained by the National Apartment Association to analyze the effects on rental housing of the proposed tax changes. His analysis of the Treasury Department's proposal indicated rents would have to increase by as much as 44%. He is now in the process of analyzing the Administration's proposed tax bill. Early results of Professor Brueggeman's work indicate that the Administration's tax proposal would also cause significant rent increases. It is highly probable that the increased rents would cause a net loss to tenants even after considering tax benefits they receive from tax reform. For example, a typical tenant might be earning $15,000 per year, and at this income level the tax reform act might save him perhaps $100 to $200 per year. However, he is perhaps paying around $350 per month in rent. A relatively modest 10% rent increase amounts to $35 per month or over $400 per year. Even using these very conservative estimates, the typical renter would suffer a net loss simply because he has chosen or is forced to rent rather than own his residence.

There are other bad effects: probably the first most immediate effect would be reduction in value of rental housing buildings. Many thousands of people, both large and small investors, who count on rental housing as a form of savings, who have worked hard to build a retirement, would find their investment eroded. Buyers would pay less for buildings since the after-tax return would be less. The provisions of the tax reform bill that make it difficult to invest in housing would result in greatly reduced construction of needed rental housing. Due to no construction, vacancy rates, which are already low at least in the Metropolitan area, would become lower. The lack of availability of housing, coupled with the pressure to restore some part of the return would exert very strong pressure for rent increases. The probable scenario is that we would experience a several year period after tax reform in which there is very little building of rental housing but a strong, steady increase in rents. Many tenants who are now paying $300 or $400 simply could not pay the $500, $600 or $700 rents that could be required. This situation would produce a great deal of hardship, as well as pressure for rent control and other negative effects. Finally, after several years, it may be that rent levels would rise to the point where owning and building rental housing is once more feasible. By that time however, many thousands of renters will simply have been forced out of the market. They would create a tremendous demand on government for some form of assistance.

I know that these are somber thoughts, but ones that must be considered along with any proposed tax reform that would make building and operating rental housing more difficult. Thank you very much for your time and consideration of these matters.

Senator DURENBERGER. Thank you very much. Our fourth panel today will discuss the implications of the tax reform plan for four significant issues of the social policy.

We are fortunate to have with us several experts in various fields of public policy, and we welcome you all.

Our first speaker will be Ms. Holtzclaw with the CPA firm of Bane, Holtzclaw & Co., a Member of the Minnesota Chapter of the National Association of Women Business Owners, who is here to address the implications of the President's tax plan for families and economic equity. Thank you for being here.

TESTIMONY OF CATHERINE E. HOLTZCLAW, PARTNER, BANE, HOLTZCLAW AND ASSOCIATES; WALTER McCLURE, PRESIDENT, CENTER FOR POLICY STUDIES; PETER RODE, RESEARCH DIRECTOR, MINNEAPOLIS URBAN COALITION; AND JIM SOLEM, EXECUTIVE DIRECTOR, MINNESOTA HOUSING FINANCE AGENCY

Ms. HOLTZCLAW. Thank you. I appreciate the opportunity to speak to you today. After hearing all these industry specialists I hope my view will hold some weight too. I'm primarily speaking to you today as myself being a single-head-of-household taxpayer, as a CPA for my clients which are primarily small closely held businesses and individuals and as a businessowner for my employees.

The topics I wish to cover this morning includes;

First, increase in the zero bracket amount for head of household and increase in exemption amounts.

Second, change from child and dependent care credit to deduction.

Third, repeal of two-earner deduction.

The fourth, increase spousal individual retirement account limit.

First of all to bring us up to speed on some of the terminology. Under the Tax Code, a head of household is a single person who maintains a home for at least one dependent. These heads of household are primarily women with children. The principle of the zero bracket amount in tax structure is to provide a minimum amount of tax-free income for basic living expenses.

Under the current law a zero bracket amount of $2,390 for unmarried individuals and head of households as, you see they are in the same categories as the single people. $3,540 for married couples filing joint returns and certain surviving spouses and $1,770 for married individuals filing separately. The sum of personal and dependency exemptions plus the zero bracket amount establishes a tax threshold below which a taxpayer's income is exempt from taxation. As family size increases, the cost of maintaining a minimum living standard increases more rapidly than the amount of income exempt from tax.

The President's proposal would increase the zero bracket amount to $2,900 for single returns, $4,000 for joint and certain surviving spouse returns, $2,000 for returns for married persons filing separately and $3,600 for head of household returns. OK. So, now we have separated the head of household and in between the marrieds and singles. The amount deductible for each personal and dependency exemption would be increased to $2,000.

Since the amount needed to maintain a household is not significantly different whether there are one or two adults, I would favor making the zero bracket amount for head of household the same as for married, as was suggested in the Economic Equity Act of 1985.

The combination of the increase in the exemption amount and increase in zero bracket amount for head of household would have significant favorable impact to the single parent households.

Second, and this is something that I feel real strongly about and I think this has a very negative impact, is the change of child care credit to a deduction would have a negative impact on the low-income workers. For lower and moderate income taxpayers earning below $30,000 a year, the deduction is worth 15 percent for each dollar compared to 20 to 30 percent under current law. Higher income families who were limited to a 20-percent credit under current law will find a deduction more valuable to them if they are in the new 25- to 35-percent brackets.

I feel this provision would go against the working lower income families, in large numbers working women. It would have a negative impact on lower income workers with children.

Third topic I would like to discuss is the repeal of the two earner deduction takes away the minor relief provided against the so-called marriage penalty. I grant that with the lowering of the brackets, the marriage penalty is somewhat lessened but not necessarily removed. Depending on the relative levels of income of the two wage earners there will still possibly be a tax increase by having to file married versus single.

I agree the two wage earner deduction may not in all cases relieve the inequity but I feel to totally eliminate this deduction without considering any other solution is wrong.

The last topic I would like to discuss and I feel is a very positive measure is the increase in the spousal individual retirement accounts will begin to give some recognition to the economic contribution of homemakers to their households and I see this as a positive thing. It will increase the opportunity for a nonworking spouse to begin to build a retirement savings, again, very positive.

Again going back to the Economic Equity Act of 1985, here's a similar provision with a graduated phase in period working up to the same $4,000 limit in 1991.

Although I would very much like to see it go to $4,000 right away to get back to the mechanical facts of life, if the revenue impact will be so great that it would lose its way in the actual final law I would prefer to see a phasein after a struggle for 4 or 5 years to contribute, to send the IRS a contribution which they just did 2 weeks ago. I have a strong fear that the revenue impact may get this washed out of the law and I would rather see it come in as a phasein rather than lose it completely.

Senator **Durenberger**. OK. Thank you very much.

Our next witness this morning is Dr. Walt McClure, president of the Center for Policy Studies. Walt, welcome.

Mr. **McClure**. Thank you, Senator. It's a pleasure to be here. I appreciate your invitation to help you carry out this good work.

You have my written testimony and, in fact, I think my message may be better carried in your own remarks in the May 23 Congressional Record.

I would simply make one brief point: Our current open-ended tax treatment of health benefits favors high-income persons over low-income persons; it favors inefficient health insurors over efficient insurors and it favors high cost inefficient providers over lower cost efficient providers of medical care. This combination of interest groups of higher wage groups, inefficient insurance companies, and inefficient providers—have consistently combined to block any reform of that tax treatment, and they have been at work again.

The first version of the President's tax proposal, known as Treasury I, actually introduced an effective approach to the problem of tax support of health care. But between the release of Treasury I and the second version known as Treasury II, somehow the gremlins managed to turn that all around and produce another bill which would favor the high-income persons over the low-income persons, the inefficient insurors over the efficient insurors and the inefficient providers over the efficient providers.

Now, from studying our own good medical care system here in Minnesota, we know that you can deliver superb medical care for at least 25 percent less than the Nation is spending today. We have excellent examples of that, such as Mayo Clinic and of our HMO's.

We also know that we don't have more efficiency in our medical care systems because there are powerful perverse incentives to punish efficient providers and reward insufficient ones. And one of those powerful incentives is the tax treatment, Treasury I and your own bill—1211 introduced an excess benefits tax. That is, the premium for excess benefits would be taxed as ordinary income, but premiums for basic benefits would remain tax free. You want to leave basic benefit tax free to help low-income people and low-wage industries have an adequate package of health benefits. That was the original reason why we put in tax free benefits. But then we found out that we left it uncapped. High wage people and inefficient insurors were taking advantage of the taxes to offer lavish tax-free programs that have little to do with necessary basic insurance protection.

So, what we now want to do is support people to have adequate and good insurance, particularly low-wage workers and other low-income people, but not support high-income people to get lavish frills.

So, we should continue to leave basic benefits tax free. But for those who begin to get elaborate or extravagant frills there is no reason for supporting such people on the tax roll. They can take very good care of themselves without tax subsidies. So we should tax them and that elaborate benefit as ordinary income. Senator, that is what your bill proposed back in 1979. That is what Senator Dole's bill proposed in 1983. That is what Senator Bradley and Congressman Gephardt proposed in 1984. It is what you have proposed again in S. 1211. And it is what the President's original version, Treasury I, proposed—that we would decide what constituted an adequate package of health insurance by the size of the premium, and then any premium above that would be taxed. So people would have a tax-free incentive to get good insurance, but if we get lavish we would be taxed for the excess.

On the other hand, what has happened to the President's proposal between its first version, Treasury I, and its second version, Treasury II, is outrageous. They turned it totally backward. They now propose to tax basic benefits, and leave excess benefits for the high-income people, inefficient insurors, and high-cost providers totally tax free. It's I totally share your outrage on that issue. With respect to health care I would think that the President's proposal would highly benefit from incorporating the original version of the excess benefits tax in Treasury I and dropping any basic benefits tax.

In sum, they would do better to take your own excess benefit tax in S. 1211 and incorporate that in the President's proposal instead of the basic benefits tax in Treasury II. Perhaps even better would be to use a refundable tax credit rather than a tax deduction for basic benefits. This would be cheaper than a tax deduction, and help lower income people, who most need help, to get good basic benefits.

Senator DURENBERGER. I want to thank you very much. Our next witness this morning is Mr. Peter Rode, who is a research director of the Minneapolis Urban Coalition and is speaking today for Steven Belton. He will be discussing the impact of the tax reform plan on our State's poor and minorities. Peter, welcome.

Mr. RODE. Thank you, Senator. My name is Peter Rode, and I am the research director of the Urban Coalition of Minneapolis.

The urban coalition works to improve the economic, social, and legal status of blacks, Hispanics, Indians, Asians, and low-income people. I am pleased to have this opportunity to speak today on behalf of our constituency.

The Federal tax system should raise adequate revenues to finance the basic operations of Government and should do so in a way that is fair and broadly based. The current tax system does neither. The President's tax plan makes some small and faltering steps in the right direction. More obvious, however, are the steps which it fails to take and the new inequities which it introduces.

Let me discuss four parts of the tax that are crucial to low-income people. The first area is tax rates.

In the past 6 years, low-income people have suffered large increases in Federal taxes. In 1979, a two-parent family of four with a poverty-level income paid 2 percent of its income in Federal Social Security and income taxes. In 1984 that same family paid more than 10 percent of its income in Federal taxes.

This burdensome tax increase came about because the President and Congress have refused to adjust income tax provisions affecting the poor for inflation. Although the cost of living has risen almost 50 percent since 1979, there has been no change in the standard deduction since 1979. And with the exception of minor changes that go into effect this year, the personal exemption and the earned income credit also have not been indexed since 1979.

As a result, poor families already suffering from massive budget cuts are being taxed deeper and deeper into poverty.

The President's plan would reverse this process and reduce the tax rate for most low-income workers. It accomplishes this by increasing the standard deduction, raising the personal exemption to $2,000, and expanding the earned income credit. These changes are long overdue.

Unfortunately, the President's proposal does not go far enough. Under the Reagan plan our analysis shows, the working poor and near-poor would still pay higher payroll taxes than they did in 1979. For example, a two-parent family of four with a poverty-level income—which is currently about $10,600—would owe 5.4 percent of its income in Federal taxes in 1986 under the Reagan plan—much less than the current rate but still more than the 1.8 percent owed in 1979. In fact, virtually all two-parent families earning less than $20,000 would find that their taxes are higher under the Reagan plan than in 1979. Clearly more can be done to move toward the more equitable tax policy that existed 6 years ago.

We recommend that the earned income credit be expanded further to compensate adequately for the inflationary damage of the past 6 years and we also suggest that the credit be modified to consider family size in determining the value of the credit.

The second point is single-parent families. The Federal Tax Code has long taxed single parents at higher rates than married couples. The President's plan reduces the extent of this form of discrimination. Nevertheless, discrimination would still exist. Under the Reagan plan, a single-parent family of four with an income of $15,000 would still owe $60 more in Federal taxes than a two-parent family of four with an identical income.

In 1980, there were 77,000 single-parent families in Minnesota, almost one of every seven families with children. I don't have to tell you that these families are disproportionately headed by women, and disproportionately consist of minority heads of household with low incomes. The President's plan would still cost Minnesota single-parent families over $3 million in extra tax. There is no just reason for imposing heavier taxes on single parents and any disparity should be completely eliminated.

The third area is child care credit. While the foregoing measures are steps in the right direction, the President is making a serious error by calling for the elimination of the child care credit. The child care credit recognizes that paid child care is not a luxury but an expense of working. For low-income parents, affordable child care is necessary if parents are to become and remain economically self-reliant.

The President's plan would eliminate the credit and replace it with a deduction. Unfortunately, low-income people do not itemize deductions. Under the President's plan, a single parent earning $15,000 per year with one child in full-time day care would see her credit drop from $648 to nothing at all, zero. In contrast, a married couple earning $100,000 would see the value of their child care credit rise from $480 to $840. While the President proclaims his tax plan as profamily, this provision represents antifamily legislation at its worst.

Not only should the child care credit be retained, it should also be made fully refundable, so that very poor parents can receive the maximum credit.

Finally, I'll talk very briefly about the Federal deficit. One of the glaring deficiencies of the Reagan plan is its failure to do anything about the huge deficits caused in part by excessive tax cuts given in 1981 to wealthy individuals and corporations. Instead of reducing the deficit by gutting programs that meet basic human needs, we should be reducing defense spending and increasing taxes on individuals and corporations having the greatest ability to pay.

The President's plan also does little to restore just taxes on corporations. Tax subsidies for corporations total close to $100 billion every year—far more than is spent on all programs for low-income people. The package of new loopholes and subsidies introduced by President Reagan in 1981 has proven to be a colossal giveaway, failing miserably at its stated purpose of increasing investment, creating jobs, and generating new revenue.

Getting rid of wasteful tax subsidies and restoring taxes lost to upper income people would provide revenue needed to operate useful Government programs. Such reform is a necessary adjunct to tax reform for the working poor. The original Treasury proposal estimates that $68 billion could be raised by closing depreciation loopholes alone; the President's current plan only raises $15 billion from this source.

We support the corporate tax reforms proposed in the original Treasury document. Failure to do so would only freeze in place an unfair and wasteful system.

In conclusion, the President's tax plan would repair part of the damage done by the tax policies pursued during the first Reagan administration. Much more needs to be done if we are to have a tax system that is fair and that provides adequate revenue for essential Government programs. We urge Congress to move toward more substantive and equitable tax reform by adopting the recommendations we have made today.

Thank you for the opportunity to present these remarks.

Senator DURENBERGER. Peter, thank you very much. Our final witness today is Jim Solem, executive director of the Minnesota Housing Finance Agency.

Mr. SOLEM. Thank you. I will try to be brief because I know you are about out of time.

The United States essentially has no national housing policy and virtually no commitment to affordable housing at the Federal level. As other witnesses have pointed out and as the chairman has indicated on many occasions, the Tax Code is really our national housing policy. Housing is capital intensive and it takes about 25 percent of all the capital generated in our economy in any given year.

Affordable capital translates into affordable housing. Tax exempt financing is a mechanism for State and local governments to provide affordable capital and help to house low- and moderate-income families who might not otherwise have adequate housing opportunities.

In Minnesota we have been responsible in the use of that opportunity provided to us in the Federal Tax Code to generate tax exempt capital. We have been responsible because Minnesota has a strong commitment to achieving public purpose in the use of those dollars and has put its money where its mouth is in terms of providing the Minnesota Housing Finance Agency, over its history, $190 million in State appropriations.

The target for those tax exempt resources is to families and individuals who most need that help.

Let me give you some examples. The Minnesota Housing Finance Agency has financed about 16,000 single-family mortgages in the history of the agency. A quarter of all those mortgages have received some additional affordability help. Thus, the agency can help lower income folks afford home ownership.

This year our income limit for that affordability help in rural Minnesota is $17,000 a year. We are helping people at low-income levels achieve home ownership using a combination of tax exempt mortgage revenue bonds and State resources and we are doing that this year for about 40 percent of all the loans that we are making.

The Minnesota Housing Finance Agency runs the largest home improvement loan program in the United States.

The most affordable housing we have today is existing housing. For a home improvement loan the agency uses State resources to write interest rates down all the way to 3 percent for individuals and families with incomes under $7,000. That is, by and large, elderly people.

Fourteen percent of all the home improvement loans we make go to people in that income category making it possible for them to have energy efficient, safe housing.

Rental housing. You asked a question a while ago about how much would it cost for a new single family or new single bedroom unit in downtown Minneapolis. The last time I looked at that number in terms of market rate financing, it is somewhere around $675 to $700 a month. Interest rates have gone down since then, my guess is in the neighborhood of $650 a month for a one bedroom, new construction, unsubsidized, basic apartment. That's no amenities, the basic structure.

What we are trying to do is take tax exempt capital, and resources provided by the agency reserves and earnings provided by the agency and target those resources to areas that otherwise simply would not get any rental housing provided. The agency is doing this in both rural Minnesota and in the central cities of this State. But we are not doing very much of it because it's almost impossible to do affordable rental housing even with tax exempt financing. So far this year the agency has done $12 million of rental housing financing. This isn't very much in the larger scheme of things and we are not doing a very good job in terms of making that affordable for lower income families.

What we are trying to do is look at the long-term care cost for the elderly in terms of medical costs, and figure out a way in which the housing resources of State and local government can help reduce long-term care costs, keep people out of nursing homes, keep people in their own homes and make it possible to care for the elderly in a more cost efficient way. The State legislature in this last session has provided the agency some new innovative resources to do that and we very much need affordable capital to go along with State dollars to meet that important public policy objective.

So, the debate over public purpose, and it's one you mentioned several times this morning, is a legitimate and appropriate debate. Minnesota, I think, has done a responsible job in meeting the public purpose standard that you and other Members of Congress would want.

There are clearly changes that could be made in the Federal law to improve public purpose, targeting in a tax exempt Housing Finance Program and in the next few weeks we will be providing you and other Members of Congress some recommendations to achieve better public purpose targeting.

But, I don't think you could find a better public purpose example anyplace in the country than the Minnesota Housing Finance Agency and the support that the legislature has provided in terms of meeting that public purpose requirement. I think it would be ironic if in the name of reform the Congress did away with the ability to generate the affordable capital that is necessary to go along with the resources provided to meet public purpose objectives.

Senator DURENBERGER. Jim, thank you very much. As I said at the beginning of the meeting, the purpose of reform is that we all should be better off after the reform than we were before the reform. And what I have heard this morning is that the President's proposal makes a beginning on reform, in terms of reducing the rates, broadening the base, reducing the tax burden on the poor, and encouraging more efficient allocation of capital. But when it comes to the test of fairness, the issue of eliminating state and local tax deductibility, an overly restrictive definition of public purpose, tax-exempt bonds, the definition of family, and the health benefit—just to name a few—certainly there are questions on the minds of a lot of Minnesotans. We should know whether the President's plan leads us in the direction of a fair tax system, in which people equally situated in terms of income and benefit of services are being taxed fairly to meet their needs.

So, difficult as those issues are, we will grapple with them. I appreciate the help of everyone who came here today and hope we can all work together to develop legislation that will result in true tax reform for this country. Thank you.

[Prepared statements of Ms. Holtzclaw and Messrs. McClure, Rode, and Solem follow:]

Catherine E. Holtzclaw, CPA
Bane, Holtzclaw & Co
2255 Doswell Ave
St Paul, MN 55108

Testimony: Tax Hearing July 3, 1985

The topics I will be covering in the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity will be:

1. Increase in Zero Bracket Amount for Head of Household and increase in exemption amounts.
2. Change from Child and Dependent Care Credit to deduction.
3. Repeal of two earner deduction.
4. Increase spousal individual retirement account limit.

I. Single Heads-of-Household Zero Bracket Amount.

Under the tax code, a head of household is a single person who maintains a home for at least one dependent. These heads-of-household are primarily women with children. The principle of the zero bracket amount in tax structure is to provide a minimum amount of tax-free income for basic living expenses.

The current law has a zero bracket amount of $2390 for unmarried individuals and head of households and $3540 for married couples filing joint returns and certain surviving spouses and $1770 for married individuals filing separately. The sum of personal and dependency exemptions plus the zero bracket amount establishes a tax threshold below which a taxpayers income is exempt from taxation. As family size increases, the cost of maintaining a minimum living standard increases more rapidly than the amount of income exempt from tax.

The proposal would increase the zero bracket amount to $2900 for single returns, $4000 for joint and certain surviving spouse returns, $2000 for returns for married persons filing separately and $3600 for head of household returns. The amount deductible for each personal and dependency exemption would be increased to $2000.

Since the amount needed to maintain a household is not significantly different whether there are one or two adults, I would favor making the zero bracket amount for head of household the same as for married, as was suggested in the Economic Equity Act of 1985.

The combination of the increase in the exemption amount and increase in zero bracket amount for head of household would have significant favorable impact to the single parent households.

II. The change of Child Care Credit to a deduction would have a negative impact on the low income workers. For lower and moderate income taxpayers earining below $30,000 a year, the deduction is worth 15 percent for each dollar compared to 20 to 30 percent under current law. Higher income families who were limited to a 20 percent credit under current law will find a deduction more valuable to them if they are in the new 25 to 35 percent brackets.

I feel this provision would go against the working lower income families, in large numbers working women. It would have a negative impact on lower income workers with children.

III. The repeal of the two earner deduction takes away the minor relief provided against the so called "Marriage Penalty". I grant that with the lowering of the brackets, the marriage penalty is somewhat lessened but not necessarily removed. Depending on the relative levels of income of the two wage earners there will still possibly be a tax increase by having to file married versus single.

I agree the two wage earner deduction may not in all cases relieve the inequity but I feel to totally eliminate this deduction without considering any other solution is wrong.

IV. The increase in the spousal individual retirement accounts will begin to give some recognition to the economic contribution of homemakers to their households and I see this as a positive thing. It will increase the opportunity for a nonworking spouse to begin to build a retirement savings.

The Economic Equity Act of 1985 has a similar provision with a graduated phase in period working up to the same $4000 limit in 1991.

July 23, 1985

TESTIMONY OF DR. WALTER McCLURE
BEFORE THE
SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
HEARING ON THE PRESIDENT'S TAX REFORM PLAN,
MINNEAPOLIS, JULY 3, 1985

EFFECTS OF THE PRESIDENT'S TAX REFORM PROPOSAL ON HEALTH CARE AND COVERAGE

I am Dr. Walter McClure, president of the Center for Policy Studies, an independent non-profit policy research organization located in Minneapolis. I appreciate your invitation to testify today on the effects of the President's tax reform proposal on health care and health insurance. I will state my conclusions first and then amplify briefly.

Conclusions

The first version of the President's proposal, known as Treasury I, included a tax on excess health insurance benefits: basic health benefits would remain tax-free, but excess benefits would be taxed. Excess benefits would be defined by the total amount of a person's health insurance premiums, whether paid by his employer or himself. Thus health insurance premiums -- whether paid by the person or his employer -- which in total exceeded a rather generous ceiling (specified in the proposal) would be subject to ordinary income tax, just like any other non-deductible expense.

Such an excess benefits tax is progressive and would fall largely on upper middle and high income persons, whose health benefits tend to be broad and lavish. Middle to low income persons, even those with very good coverage, would entirely escape the tax as long as their premium was below the generous ceiling.

This excess benefits tax should also have very favorable effects on health insurance and the health care system. Because health insurance with excessive benefits would no longer be tax-free, health insurers would finally be prodded to install effective cost control measures in their health insurance plans; effective measures will allow them to offer excellent plans that cost less than the ceiling and so would be tax-free. In turn...if done right...such health insurance plans are likely to reward efficient, high quality providers of health care at the expense of providers with less quality or efficiency. The quality and efficiency of the health care system should be markedly increased thereby.

In sum, an excess benefits tax, such as that in Treasury I, appears to favor (1) low income persons over higher income persons, (2) cost-effective health insurers over inefficient health insurers, (3) efficient high-quality providers over inefficient providers, and (4) the quality and efficiency of the health care system generally for all its patients.

Not so, Treasury II...the second version of the President's tax reform proposal. Treasury II replaces the excess health benefits tax with a basic benefits tax. A basic benefits tax is just the reverse of an excess benefits tax. It would tax basic benefits but make excess benefits tax-free. Thus the sum of a person's health insurance premiums -- whether paid by the person or his employer -- up to a specified ceiling would be taxed as ordinary income; but any portion of the sum exceeding the ceiling would be entirely tax-free!

A basic benefits tax will have exactly the opposite effect as an excess benefits tax. It is regressive, because lower income persons with only fair to good coverage pay the same tax as higher income persons with extravagant coverage.

It also favors the inefficient and profligate health insurer over the efficient and effective insurer, because the inefficient insurer with no effective cost-control measures would have no more tax placed on his excessive premiums than the conscientious insurer with the same benefits at more reasonable premiums. And, because this tax favors plans with no cost-control measures, it would continue the long-standing insurance incentives that favor inefficient providers over high-quality efficient providers.

In sum, a basic benefits tax, such as that in Treasury II, would: (1) favor high income persons at the expense of low income persons, (2) favor high cost insurers over good but low cost insurers, (3) favor inefficient providers over high quality efficient providers, and (4) continue the perverse incentives in the present health care system against efficient high-quality care.

I highly applaud the President's effort to reform the tax system. With respect to health insurance, I conclude the President's proposal would be much improved were the new basic benefits tax in Treasury II. to be replaced by the original excess benefits tax in the earlier Treasury I. version.

Further Observations

I would simply amplify the above conclusions with the following observations. First, it is now well-established that high quality medical care can be rendered by efficient providers at up to half the cost of the least efficient providers. For example, the noted Mayo Clinic renders superb care at 25% less cost...per patient per year...than the national average for comparable patients.[1] Much additional, equally compelling data can be offered in support of this point.[2] Were all providers to become as efficient as Mayo Clinic and other equally efficient high-quality providers, the nation's medical bill could be reduced by at least 25%!

But traditional health insurance does not encourage such efficient high-quality medical care. The inefficient provider, who uses more services to get the same result and charges more aggressively for each service, does not lose a single patient thereby; he just earns more on each patient he treats, and insurance pays. The efficient provider, who uses fewer services to get the same result and charges more reasonably for each service, does not gain a single patient thereby; he just earns less on each one. Consequently most providers have moved gradually to increasingly costly inefficient styles of practice.

The old, completely tax-free treatment of employer-based health insurance encourages this profligate style of medical care, for the insurer has no reason to contain the costs of providers. Quite the reverse, the insurer, who is usually paid a percentage of total claims, loves high-cost inefficient providers. He simply adds his percentage to the claim and passes it on to the employer and employee. Thus under the old tax-free treatment of health premiums, the government simply winds up relinquishing revenue in order to support the most extravagant types of insurance and the providers, insurers, and higher income tax-payers who benefit from it. The lost revenue must be made up either by increased taxes on other taxpayers, or by borrowing (i.e. by an increase in the federal deficit, with all that implies).

The original objective of tax-free employer-paid health insurance was, and is, to help all Americans obtain adequate access to needed medical care while protecting them from undue medical expense. It is not to support profligate insurers and providers at the tax-payers' expense. Thus the original objective remains valid, but the vehicle of totally tax-free benefits does not.

A more sensible approach is an excess benefits tax. Basic benefits would continue to be a tax-free deduction, but excess benefits would be taxed as ordinary income. The government could determine by survey the prevailing premiums of the most efficient insurers and providers offering excellent health care and coverage. This premium can be established as the ceiling beyond which health insurance would be taxed as excessive. All persons with health insurance costing less than the ceiling -- whether paid by themself or their employer -- would pay no tax. They would continue to have all the traditional support and encouragement of the tax system to obtain good or excellent coverage. On the other hand, higher income persons with inefficient or lavish insurance would have any excess premium treated as ordinary taxable income. Thus employers, unions, and employees would all have every incentive to choose excellent efficient medical care and coverage plans which are tax-free; they would no longer have any tax incentive to choose inefficient plans whose excess premium would now be taxed.

The inequity and unfavorable incentive effects of open-ended tax-free benefits on taxpayers, insurers, and providers were pointed out more than fifteen years ago[3], and the excess health benefits tax was proposed as a remedy. It has been supported by most experts on health care economics since.[4,5] It has been introduced as legislation by distinguished Congressmen on more than one occasion.[6] An especially good excess benefits tax proposal is included in S. 1211 (Durenberger, R-Minn., 1985). Perhaps an even better excess benefits tax approach would be to replace the basic benefits deduction with a basic benefits credit.[5] All these proposals for an excess health benefits tax have been consistently blocked by the special interests who gain from the old tax treatment. They appear to be at work again in Treasury II.

Recommendation:

I urge the President and Congress to move forward on tax reform including an excess health benefits tax as in the President's original proposal or, even better, as in S. 1211 or, perhaps still better, by use of a basic benefits credit. I urge them to oppose any basic health benefits tax, whether in the President's or any other proposal.

References:

1. W. McClure and D. Shaller, Variations in Medicare Expenditures; Health Affairs 3 (Summer 1984) 120-129 and citations.

2. W.McClure, The Competition Strategy for Medical Care; Annals A.A.P.S.S. 468 (July 1983) 30-47 and citations.

3. M. Feldstein, The Welfare Loss of Excess Health Insurance; J.Pol.Econ. 82,2 (March 1973) 251-280 and citations.

4. C. Havighurst, Containing Health Care Costs; J.Health Pol.Pol.Law, 1 (Winter 1977) 471

   P. Ginsburg, Altering the Tax Treatment of Employment Based Health Insurance; Milbank Qtly. 59 (1981) 224

5. W. McClure and M. Schmitt, Options to Eliminate Inflationary Health Insurance Subsidies in the Federal Income Tax; (memorandum, InterStudy, Mpls.,1978)

   A. Enthoven, A New Proposal to Reform the Tax Treatment of Health Insurance; Health Affairs 3 (Spring 1984) 21

6. S. 1485 (Durenberger, R-Minn.) 1979
   H.R. 6944 (Gephardt, D-Mo.) 1982
   S. 2817 (Bradley, D-NJ.) 1982
   S. 640 (Dole, R-Kan.) 1983
   S. 1211 (Durenberger, R-Minn.) 1985

STATEMENT OF
STEVEN L. BELTON, PRESIDENT,
URBAN COALITION OF MINNEAPOLIS,
ON THE
PRESIDENT'S TAX REFORM PLAN
BEFORE THE
SENATE SUBCOMMITTEE
ON
INTERGOVERNMENTAL RELATIONS

SENATOR DAVID DURENBERGER,
CHAIR

PREPARED AND PRESENTED BY
PETER RODE,
RESEARCH DIRECTOR,
UCM

ST. PAUL, MINNESOTA
JULY 3, 1985

SENATOR DURENBERGER, MEMBERS OF THE COMMITTEE AND GUESTS: MY NAME IS STEVEN BELTON, AND I AM PRESIDENT OF THE URBAN COALITION OF MINNEAPOLIS. THE URBAN COALITION WORKS TO IMPROVE THE ECONOMIC, SOCIAL AND LEGAL STATUS OF ASIANS, BLACKS, HISPANICS AND INDIANS AND LOW-INCOME PEOPLE IN GREATER MINNEAPOLIS. I AM PLEASED TO HAVE THIS OPPORTUNITY TO SPEAK TODAY ON BEHALF OF OUR CONSTITUENCY.

IN OUR VIEW, THE BASIC OBJECTIVE OF THE FEDERAL TAX SYSTEM IS TO RAISE ADEQUATE REVENUES TO FINANCE THE BASIC OPERATIONS OF GOVERNMENT AND TO DO SO IN A WAY THAT IS FAIR AND BROADLY BASED. THE CURRENT TAX SYSTEM DOES NEITHER. THE PRESIDENT'S TAX PLAN MAKES SOME SMALL AND FALTERING STEPS IN THE RIGHT DIRECTION. MORE OBVIOUS, HOWEVER, ARE THE STEPS WHICH IT FAILS TO TAKE AND THE NEW INEQUITIES IT INTRODUCES.

TAX RATES

IN THE PAST SIX YEARS, LOW-INCOME PEOPLE HAVE SUFFERED LARGE INCREASES IN FEDERAL TAXES. IN 1979, A TWO-PARENT FAMILY OF FOUR WITH A POVERTY-LEVEL INCOME PAID 2% OF ITS INCOME IN FEDERAL SOCIAL SECURITY AND INCOME TAXES. IN 1984 THAT SAME FAMILY PAID MORE THAN 10% OF ITS INCOME IN FEDERAL TAXES.

THIS BURDENSOME TAX INCREASE CAME ABOUT BECAUSE THE PRESIDENT AND CONGRESS HAVE REFUSED TO ADJUST INCOME TAX PROVISIONS AFFECTING

THE POOR FOR INFLATION. ALTHOUGH THE COST OF LIVING HAS RISEN ALMOST 50% SINCE 1979, THERE HAS BEEN NO CHANGE IN THE STANDARD DEDUCTION SINCE 1979. WITH THE EXCEPTION OF MINOR CHANGES THAT GO INTO EFFECT THIS YEAR, THE PERSONAL EXEMPTION AND THE EARNED INCOME CREDIT ALSO HAVE NOT BEEN INDEXED SINCE 1979.

RISING FEDERAL TAXES--COMBINED WITH MASSIVE BUDGET CUTS FOR PROGRAMS SERVING LOW-INCOME PEOPLE--HAVE DRASTICALLY REDUCED THE ALREADY MEAGER INCOMES OF AMERICA'S POOREST CITIZENS. POOR FAMILIES ARE BEING TAXED DEEPER AND DEEPER INTO POVERTY.

THE PRESIDENT'S PLAN WOULD REVERSE THIS PROCESS AND REDUCE THE TAX RATE FOR MOST LOW-INCOME WORKERS. IT ACCOMPLISHES THIS BY INCREASING THE STANDARD DEDUCTION, RAISING THE PERSONAL EXEMPTION TO $2,000, AND EXPANDING THE EARNED INCOME CREDIT. THESE CHANGES ARE LONG OVERDUE.

UNFORTUNATELY, THE PRESIDENT'S PROPOSAL DOES NOT GO FAR ENOUGH. UNDER THE REAGAN PLAN, THE WORKING POOR AND NEAR-POOR WOULD STILL PAY HIGHER PAYROLL TAXES THAN THEY DID IN 1979. FOR EXAMPLE, A TWO-PARENT FAMILY OF FOUR WITH A POVERTY-LEVEL INCOME (ABOUT $10,600 IN CURRENT DOLLARS) WOULD OWE 5.4% OF ITS INCOME IN FEDERAL TAXES IN 1986--MUCH LESS THAN THE CURRENT RATE BUT STILL MORE THAN THE 1.8% OWED IN 1979. IN FACT, VIRTUALLY ALL TWO-PARENT FAMILIES EARNING LESS THAN $20,000 WOULD FIND THAT THEIR TAXES ARE HIGHER UNDER THE REAGAN PLAN THAN IN 1979. [SEE ATTACHMENT.]

WE BELIEVE THAT THE TAX POLICY SHOULD BE DESIGNED TO INSURE THAT PEOPLE BELOW THE POVERTY LEVEL ARE NOT REQUIRED TO PAY INCOME TAXES AND TO OFFSET A LARGE PART OF THE HIGHLY REGRESSIVE SOCIAL

SECURITY TAX.

THE 1979 TAX LEGISLATION MET THESE GOALS MORE EFFECTIVELY THAN THE PRESIDENT'S CURRENT PLAN. WE RECOMMEND THAT THE EARNED INCOME CREDIT BE EXPANDED FURTHER TO COMPENSATE ADEQUATELY FOR THE INFLATIONARY DAMAGE OF THE PAST SIX YEARS. WE ALSO SUGGEST THAT THE CREDIT BE MODIFIED TO CONSIDER FAMILY SIZE IN DETERMINING THE VALUE OF THE CREDIT.

SINGLE-PARENT FAMILIES

THE FEDERAL TAX CODE HAS LONG TAXED SINGLE PARENTS AT HIGHER RATES THAN MARRIED COUPLES. THE PRESIDENT'S PLAN IS TO BE COMMENDED FOR REDUCING THE EXTENT OF THIS DISCRIMINATION. NEVERTHELESS, DISCRIMINATION WOULD STILL EXIST. UNDER THE REAGAN PLAN, A SINGLE-PARENT FAMILY OF FOUR WITH AN INCOME OF $15,000 WOULD STILL OWE $60 MORE IN FEDERAL TAXES THAN A TWO-PARENT FAMILY OF FOUR WITH AN IDENTICAL INCOME.

IN 1980, THERE WERE 77,000 SINGLE-PARENT FAMILIES IN MINNESOTA--ALMOST ONE OF EVERY SEVEN FAMILIES WITH CHILDREN. DESPITE ITS IMPROVEMENTS OVER PRESENT POLICY, THE PRESIDENT'S PLAN WOULD STILL COST MINNESOTA'S SINGLE-PARENT FAMILIES OVER $3 MILLION IN EXTRA TAXES. THERE IS NO JUST REASON FOR IMPOSING HEAVIER TAXES ON SINGLE PARENTS. ANY DISPARITY SHOULD BE COMPLETELY ELIMINATED.

CHILD CARE CREDIT

WE STRONGLY OPPOSE THE PRESIDENT'S PLAN TO ELIMINATE THE CHILD CARE CREDIT. THE CHILD CARE CREDIT RECOGNIZES THAT PAID CHILD CARE

IS NOT A LUXURY BUT AN EXPENSE OF WORKING. FOR LOW-INCOME PARENTS, AFFORDABLE CHILD CARE IS NECESSARY IF PARENTS ARE TO BECOME AND REMAIN ECONOMICALLY SELF-RELIANT.

THE PRESIDENT'S PLAN WOULD ELIMINATE THE CREDIT AND REPLACE IT WITH A DEDUCTION. DEDUCTIONS PRIMARILY BENEFIT MIDDLE- AND UPPER-INCOME WORKERS AND EXCLUDE LOW WAGE EARNERS, BECAUSE LOW-INCOME PEOPLE USUALLY DO NOT EARN ENOUGH TO ITEMIZE DEDUCTIONS.

UNDER THE PRESIDENT'S PLAN A SINGLE PARENT EARNING $15,000 PER YEAR WITH ONE CHILD IN FULL-TIME DAY CARE WOULD RECEIVE NO CREDIT AT ALL, LOSING $648 AVAILABLE UNDER CURRENT LAW TO OFFSET DAY CARE COSTS. IN CONTRAST, A MARRIED COUPLE EARNING $100,000 WOULD SEE THE VALUE OF THEIR CHILD CARE CREDIT RISE FROM $480 TO $840. IRONICALLY, THE PRESIDENT REFERS TO HIS TAX PLAN AS "PRO-FAMILY," WHEN THE REGRESSIVE NATURE OF HIS CHILD CARE DEDUCTION IS ONLY "PRO-WEALTHY FAMILIES."

NOT ONLY SHOULD THE CHILD CARE CREDIT BE RETAINED. IT SHOULD ALSO BE MADE FULLY REFUNDABLE, SO THAT VERY POOR PARENTS CAN RECEIVE THE MAXIMUM CREDIT.

DEDUCTIONS FOR STATE AND LOCAL TAXES

THE PRESIDENT'S PROPOSAL TO ELIMINATE THE DEDUCTION FOR STATE AND LOCAL TAXES WOULD NOT DIRECTLY AFFECT LOW-INCOME PEOPLE, SINCE FEW ARE ABLE TO ITEMIZE DEDUCTIONS. HOWEVER, IT WOULD SHARPLY PENALIZE STATES LIKE MINNESOTA WHICH BELIEVE IN HAVING A PROGRESSIVE TAX SYSTEM. ELIMINATING THE DEDUCTION MAY LEAD MANY MIDDLE- AND UPPER-INCOME TAXPAYERS TO REDUCE THEIR SUPPORT FOR A PROGRESSIVE TAX SYSTEM BECAUSE UNDER A PROGRESSIVE SYSTEM THEY PAY MORE STATE

TAXES--WHICH WOULD NOT BE DEDUCTIBLE.

ELIMINATING STATE AND LOCAL DEDUCTIONS WILL PUT PRESSURE ON STATES TO REDUCE THE TAX BURDEN ON CITIZENS. THAT, IN TURN, WILL CAUSE THE STATE TO EITHER REDUCE OVERALL STATE SPENDING, WITH THE HIGH PROBABILITY THAT LOW-INCOME PROGRAMS WOULD BEAR THE BRUNT OF THE CUTS--OR TO SHIFT TO REGRESSIVE TAXES, SUCH AS SALES AND PROPERTY TAXES, WHICH WEIGH MORE HEAVILY ON THE POOR.

THE FEDERAL GOVERNMENT SHOULD NOT INTERFERE WITH STATE AND LOCAL REVENUE SOURCES BY IMPOSING DOUBLE TAXATION.

THE FEDERAL DEFICIT

ONE OF THE MAJOR DEFICIENCIES OF THE REAGAN PLAN IS ITS FAILURE TO DO ANYTHING ABOUT THE HUGE DEFICITS CAUSED IN PART BY EXCESSIVE TAX CUTS GIVEN IN 1981 TO WEALTHY INDIVIDUALS AND CORPORATIONS. THE PRESIDENT'S ONLY APPARENT PLAN TO REDUCE THE DEFICIT IS TO GUT PROGRAMS THAT MEET BASIC NEEDS. WE BELIEVE THAT DEFENSE SPENDING SHOULD BE REDUCED AND TAXES INCREASED ON THOSE WHO BENEFITTED MOST FROM THE 1981 TAX CUTS AND THE RECENT ECONOMIC RECOVERY.

UNLIKE THE WORKING POOR, WHOSE TAXES HAVE RISEN DRAMATICALLY IN RECENT YEARS, THE WELL-TO-DO HAVE ALREADY BEEN THE BENEFICIARIES OF MASSIVE TAX CUTS. YET, THE PRESIDENT PROPOSES FURTHER CUTS. FAMILIES WITH INCOMES OVER $200,000 WOULD RECEIVE AN AVERAGE TAX CUT OF 10.7%, CONSIDERABLY LARGER THAN THE CUT TO BE RECEIVED BY MIDDLE-INCOME TAXPAYERS EARNING BETWEEN $20,000 AND $50,000.

EQUITY AS WELL AS SOUND FISCAL POLICY REQUIRES THAT REDUCTIONS FOR THE WELL-TO-DO BE CANCELLED.

THE PRESIDENT'S PLAN ALSO DOES LITTLE TO RESTORE JUST TAXES ON CORPORATIONS. TAX SUBSIDIES FOR CORPORATIONS TOTAL CLOSE TO $100 BILLION EVERY YEAR--FAR MORE THAN IS SPENT ON ALL PROGRAMS FOR LOW-INCOME PEOPLE. THE PACKAGE OF NEW LOOPHOLES AND SUBSIDIES INTRODUCED BY PRESIDENT REAGAN IN 1981 HAS PROVEN TO BE A COLOSSAL GIVEAWAY, FAILING MISERABLY AT ITS STATED PURPOSE OF INCREASING INVESTMENT, CREATING JOBS, AND GENERATING NEW REVENUE.

GETTING RID OF WASTEFUL TAX SUBSIDIES AND RESTORING TAXES LOST TO UPPER-INCOME PEOPLE WOULD PROVIDE REVENUE NEEDED TO OPERATE USEFUL GOVERNMENT PROGRAMS. SUCH REFORM IS A NECESSARY ADJUNCT TO TAX REFORM FOR THE WORKING POOR. THE ORIGINAL TREASURY PROPOSAL ESTIMATES THAT $68 BILLION COULD BE RAISED BY CLOSING DEPRECIATION LOOPHOLES ALONE: THE PRESIDENT'S CURRENT PLAN ONLY RAISES $15 BILLION FROM THIS SOURCE.

WE SUPPORT THE CORPORATE TAX REFORMS PROPOSED IN THE ORIGINAL TREASURY DOCUMENT. FAILURE TO DO SO WOULD ONLY FREEZE IN PLACE AN UNFAIR AND WASTEFUL SYSTEM.

CONCLUSION

THE PRESIDENT'S TAX PLAN WOULD REPAIR PART OF THE DAMAGE DONE BY THE TAX POLICIES PURSUED DURING THE FIRST REAGAN ADMINISTRATION. MUCH MORE NEEDS TO BE DONE IF WE ARE TO HAVE A TAX SYSTEM THAT IS FAIR AND THAT PROVIDES ADEQUATE REVENUE FOR ESSENTIAL GOVERNMENT PROGRAMS. WE URGE CONGRESS TO MOVE TOWARD MORE SUBSTANTIVE AND EQUITABLE TAX REFORM BY ADOPTING THE RECOMMENDATIONS WE HAVE MADE TODAY.

ATTACHMENT

PERCENT OF INCOME PAID IN FEDERAL SOCIAL SECURITY AND INCOME TAXES

(A) Two-Parent Family of Four

Income (1986 dollars)	1979	1984	1986
10,000	-0.7%	7.9%	3.1%
12,500	4.3%	10.8%	6.5%
15,000	9.2%	12.5%	10.2%
17,500	11.3%	13.7%	11.9%
20,000	12.8%	14.8%	13.2%

(B) Single-Parent Family of Four

Income (1986 dollars)	1979	1984	1986
10,000	-0.3%	9.3%	3.1%
12,500	6.2%	12.2%	7.0%
15,000	11.0%	13.8%	10.6%
17,500	13.0%	15.3%	12.2%
20,000	14.4%	16.5%	13.5%

NOTE: Tax calculations based on the following assumptions:

- Wage and salary income only. No income from pensions, unemployment insurance, social security, or public assistance.
- One wage-earner per family.
- No itemized deductions.
- No child care credit.

MINNESOTA
HOUSING
FINANCE
AGENCY

TESTIMONY

JAMES J. SOLEM
EXECUTIVE DIRECTOR
MINNESOTA HOUSING FINANCE AGENCY

Wednesday, July 3, 1985

SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS
Room 15 - Minnesota State Capitol

INTRODUCTION

The Minnesota Housing Finance Agency was created in 1971 and issued its first debt in 1973. Since that time, the Agency has issued $1,897,000,000 of tax exempt bonds.

The State of Minnesota has, during that same period of time, appropriated approximately $190,000,000 to the Agency to be used to assist in meeting the housing needs of low and moderate income families. The Minnesota Housing Finance Agency, perhaps more than almost any other issuer in the United States, has had an opportunity to use the resources available by the issuance of tax exempt debt to meet clear public purpose housing objectives.

At a time when the federal government has virtually abandoned its role in assisting in the provision of affordable housing, the role of the state and local governments in providing limited housing assistance through the use of tax exempt bonds is more important than ever.

I will point out the program areas where the Housing Finance Agency has combined State resources with tax exempt financing to provide housing programs and the extent to which tax exempt financing is a vital element in a continued State and local effort to provide affordable housing opportunities.

The Housing Finance Agency has used tax exempt financing in three major program areas: (1) the financing of rental housing; (2) single family mortgages; and (3) a home improvement loan program. Of the debt issued by the Agency, 51% has been for single family mortgages, 16% for home improvement loans, and 33% for rental housing.

SINGLE FAMILY MORTGAGE PROGRAM

It's important to understand that the programs developed using tax exempt revenue bonds help people. In Minnesota, 16,000 plus families have received tax exempt financing which assisted them in owning a home. The 1984 typical MHFA borrower is a household of a little over two people purchasing a home for the first time with a 5% downpayment. The typical borrower is about 28 years old with the co-borrower of age 26. This typical family has an average income of $25,900 and is obtaining a $47,900 mortgage on a $54,300 home.

Outside the metropolitan area, the average income of that typical borrower family is about $22,000 and they are obtaining a $38,000 mortgage on a $43,000 home.

Of the homes financed in 1984, 38% were newly constructed; 68% were existing homes.

The tax exempt financing enabled the Agency to provide opportunities to substantially increase the affordability for potential homebuyers. In 1984, a 13-1/4% fixed rate 30 year mortgage on a $50,000 loan would have resulted in a principal and interest payment of $563 a month. That same mortgage at the 9.95% interest rate currently provided by the Housing Finance Agency results in a $437 a month payment.

This $126 a month savings means a family can earn $500 less per month or $6,000 less per year to qualify for a Housing Finance Agency loan. Families with substantially less income can thus own a home.

Approximately a quarter of all of the mortgage loans made by the Housing Finance Agency have received some form of State assistance to make them even more affordable to lower income borrowers. This program is called the Homeownership Assistance Fund and provides either a no interest downpayment loan or a no interest monthly affordability loan to help reduce monthly payments for the first ten years of the mortgage. These funds are available to borrowers who otherwise would not be able to qualify for a tax exempt mortgage. The income limits are $23,000 for the metropolitan area and $17,000 for the non-metropolitan area.

The mortgage program is currently provided through 213 lenders at 254 locations throughout the state of Minnesota. In many of the smaller communities, the only mortgage lending activity provided comes from the program of the Minnesota Housing Finance Agency.

The Agency also works very closely with local governments. Our Municipal Set-Aside Program has, to date, selected 30 cities to receive a special allocation of mortgage funds to help meet local development issues. These include cities such as Northfield, Albert Lea, Red Wing, Austin, Mankato, Litchfield, Winona, East Grand Forks, Faribault, and others.

In short, tax exempt bonds combined with substantial State resources are helping first time homeowners in Minnesota afford the American dream. This is done in a close working relationship with local governments and the private sector.

HOME IMPROVEMENT LOAN PROGRAM

The Minnesota Housing Finance Agency has the largest Home Improvement Loan Program in the United States. This Home Improvement Loan Program is provided through 238 lending institutions in all areas of the state. The interest rate on home improvement loans varies from 3% for borrowers with an income of under $7,000 to 11% for borrowers with incomes of $17,000 to $24,000. The income limit on the program is $24,000.

The low interest rate is available because of substantial State appropriations to the program. Since the program began in 1975, the State of Minnesota has provided $53.3 million to assist in writing down interest rates to make home improvement loans more affordable. Over 42,000 home improvement loans have been made by the Agency.

The typical borrower is a homeowner of age 42, even though about 14% of all borrowers are over age 62, with an average income of $19,000 a year. The average age of the property for which the loan is made is 48 years of age and about one-third of all loans are made in the metropolitan area; two-thirds outside the Twin Cities metropolitan area. Thus, this program is an important housing resource for non-metropolitan Minnesota.

About 17% of all the funds are used for energy related improvements and about 32% are used for structural additions, modifications, or alterations on an existing structure.

The average Agency home improvement loan has a 9-1/2 year term with an amount of $6,800. The average interest rate is 9-1/2%. The typical Housing Finance Agency home improvement loan has a payment of $92 per month. The Agency's reduced interest rate provides a $2,000 savings to the homeowner over the term of the loan.

The Agency's 15 year loan maximum term provides substantial opportunities for affordable monthly payments in comparison to the shorter term home improvement loans at much higher interest rates available from lending institutions.

This is an example of where the State of Minnesota, using its resources along with the proceeds from the sale of tax exempt bonds, has made a major commitment to continued housing quality and to making resources affordable and to providing these resources in all areas of the state. Without the Home Improvement Loan Program of the Housing Finance Agency there are literally hundreds of small cities in Minnesota that would have no affordable improvement monies available for maintaining the condition, quality, and energy efficiency of Minnesota's housing stock.

The most affordable housing we have is the housing which exists now. This program has been structured to make certain that Minnesota does the best possible job of maintaining its existing housing stock and maintaining the affordability of this housing.

RENTAL HOUSING

The Housing Finance Agency has financed 250 rental developments for a total of 17,324 units. These developments are found in 155 different communities and in 75 different counties.

Section 8 assistance from the federal government is provided to 14,000 of these units. Minnesota is one of the few states in the country that has financed more family housing than elderly housing (9,092 of these units for families and 8,232 for the elderly).

There is no longer a subsidy available from the federal government to help make rental housing affordable. The State of Minnesota and the Housing Finance Agency have used limited resources available to them in the last two years to try and add to the affordability of rental housing being financed.

Approximately $8 million of State appropriations and Agency reserves were used in conjunction with the proceeds of tax exempt bonds to make rental housing affordable. These resources were used in a number of different ways. Examples include $5,000 per unit grants to developers to encourage the construction of three and four bedroom apartments for families, interest rate subsidies to developers to make developments for the elderly feasible in areas of the state outside the seven county metropolitan area, a shallow subsidy rental program providing $150 per month to elderly tenants, and a graduated payment program for developers to make multi-family rental developments feasible based upon existing rent structures.

This has resulted in 72 units of elderly and 241 units of family rental housing outside the metropolitan area. In these 8 communities, there is virtually no possibility of private financing for rental housing at any interest rate.

Even though these resources are limited, they have been carefully targeted and directed toward providing needed housing in areas that would not otherwise have affordable rental housing available.

The rental housing issue is directly related to a larger issue facing this state and the nation -- that is providing long term affordable care including housing alternatives for our rapidly increasing elderly population. The Housing Finance Agency has been a part of an effort on several State agencies to develop a comprehensive State strategy on aging. The Agency received substantial appropriations in this past Session of the Legislature to assist in developing affordable alternatives for the elderly in the fact of diminished if not disappearing federal housing resources.

For most communities in Minnesota, there will be no rental housing provided without the advantages which result from both the availability of tax exempt financing as well as the other advantage provided to real estate in the current tax code. Tax exempt financing provides about $100 a month reduction in rents compared to rates available for conventional financing if indeed that financing is available in many areas of the state. This differential allows for important increases in affordability but it does not begin to provide the same affordability that the federal Section 8 rent assistance program provided.

Thus, even with tax exempt financing and the resources of the Agency, the State and local governments, the ability to serve income levels comparable to those in public housing or the Section 8 program simply no longer exists. The Congress should understand the extent to which affordable rental housing is simply not possible given the abdication of responsibility by the federal government for the production of affordable rental housing.

CONCLUSION

Although time hasn't permitted, the same arguments could and would be made about programs for energy and economic development at the Minnesota Department of Energy and Economic Development. Hereto Minnesota has targeted the use of tax exempt bond proceeds to important activities for which there are no replacements at the federal level. Additional material on these programs will be provided in my extended remarks for the record.

The Minnesota Housing Finance Agency has helped well over 100,000 households in Minnesota obtain better, more affordable housing. This has been done through a combination of tax exempt bonds, State appropriations, and Agency resources. All of this activity has been targeted to individuals and families who might not have otherwise been able to afford the type of housing assistance made available. For State and local governments there is no alternative to the continued availability of some form of tax exempt housing to help with affordable housing opportunities. In Minnesota, the State has made a major commitment to providing the resources so the Agency might provide these programs in all areas of the state. Time has not permitted a summary of the economic impact of these programs. It is obviously extensive and important.

In short, without the continued availability of tax exempt financing, the opportunities for affordable housing in Minnesota will be substantially diminished and given the absence of federal housing programs, the possibilities for affordable housing for many Minnesotans will be greatly diminished if not lost entirely.

A Speaker. Senator Durenberger?

Senator Durenberger. Yes.

A Speaker. I would like to address the spending side a little bit, specifically Central America. Now, last week, I know you are Catholic, but you might be interested in this. Last week, we heard * * * were down in Nicaragua and tell us about a 119 children who have been murdered by the Contras including 12 mutilated children, they weren't caught in any crossfires, these were children that were drawn out—drug out of their homes and murdered by these so-called founding fathers, murdered and raped * * * that's why we are losing all our tax breaks and all our benefits and all our incentives, because we are wasting it on projects like that. Whereas, in Guatemala where there is 36—just last week—third week of June 36 people disappeared in the third week of June, nothing in the press, not a thing. I just can't understand how we can—how we can support—how this stuff can go on week after week, hundreds of mutilated corpses strewn throughout the countryside in Guatemala which is controlled by the right. A lot of people make analogies to Vietnam, but I don't think—there is one big difference about what is going on in Vietnam and right now. Then there was, in Vietnam and that's * * * this time the killing fields isn't on the left, this time the killing field is the ultra right and we are supporting, you voted for the Contras and you are supporting this genocide that's going on in El Salvador and Guatemala and I just can't understand it.

Last time there were mutilated children was when Joseph Mengela, the "Angel of Death" of the Nazis was murdering, doing experiments on children in Nazis Germany and that's what those Contras are doing right now.

A Speaker. Where are the Sandinistas that are killing people?

A Speaker. There are less than 100 internal political killings in Nicaragua since the Sandinistas took power * * * Contras that took over, 50,000 in the last 5 years in Guatemala. 45,000 in El Salvador. These are unarmed civilians, these aren't—these aren't people that are caught in a crossfire of war.

A Speaker. You know the national seal of the Sandinistas is beheading a marine, that's the national seal of the Sandinistas.

A Speaker. If we are going to attack their people——

A Speaker. The Sandinistas just took over—inaudible—and they killed all the——

A Speaker. Shut up. This is not on the agenda. This is a bogus issue.

A Speaker. This is not a bogus issue.

A Speaker. What is really important, we have to go after terrorists in this world and the terrorists are attacking the United States.

A Speaker. Then why don't we go after the terrorists that are murdering these innocent people in Nicaragua and Guatemala and El Salvador.

A Speaker. We should start with Iran and the—inaudible—and Coral Islands, that's what we should do. We should bomb military targets in—inaudible—these are the terrorists that are killing Americans.

A SPEAKER. Senator Durenberger, if you would not meet with us people——

Senator DURENBERGER. Tom, I have heard the message. I got your message.

A SPEAKER. We can never talk to you, we can never talk, we can never get a dialog with you. You won't meet with us.

Senator DURENBERGER. I got your message.

A SPEAKER. We have 100,000 people marching on Washington, we came all that way and you wouldn't meet with us when we got all the way to Washington, you wouldn't meet with us here in Minneapolis but this nonsense goes on and on and on. I mean, these people don't—these are fascists, I don't think * * * there is no other way to describe it, when they take all the people and murder them by the thousands, I'm concerned about Communism and totalitarianism as anyone but this is way out of bounds of what is going on, but you are on the ten percent intelligence committee, you could do something about it. You could make sure that the CIA gets Edgar Chamorro who is with the FBI * * * just recently and I have this article that I would like to give you in a minute * * * has left because he * * * the CIA got involved, they started teaching a lot of these tactics, just like Operation Phoenix in Vietnam where we murdered all the Viet Cong and by the time the war was ended, the CIA had so decimated the Viet Cong, the only resistance that was left. Now, they are going to do the same thing in Central America. Now, they are going to go in and kill all the good people and eliminate all those that stand up and have the courage to stand up then they are going to go into the CIA and teach these people if we eliminate them we will have dictatorships down there for another 4 years. I mean, something has to be done about this stuff. Reagan is not going to do it. It's up to the moderate Republicans like yourself to stand in his way. They are talking about invading Nicaragua now like rolling off a log, they say, I don't think it would be rolling off a log. I think we would lose thousands and thousands of our good men——

Senator DURENBERGER. Tom, thank you very much. This hearing is ended.

[Whereupon the subcommittee was recessed to reconvene at the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

LIFE INSURANCE AND THE ADMINISTRATION'S TAX REFORM PROPOSAL

prepared by Dean A. Wahlberg
Vice President, Corporate Affairs
The Minnesota Mutual Life Insurance Company

July 3, 1985

The Administration's tax reform proposal offers only minor improvements from last fall's Treasury Department proposal. What remains, unfortunately, is a very serious threat to the financial well-being of both policyowners and insurers. The new or increased taxes to which they would be subject would seriously damage the financial security of millions of Americans.

Why does the life insurance industry oppose taxing the so-called "inside buildup" of cash values? Why do we believe the proposals to tax those cash values should be rejected? The reasons are many:

1. The proposals are based on a faulty concept of the nature of level premium life insurance. The cash values in a whole life contract are not comparable to savings accounts or certificates of deposit, as is suggested in the Administration's proposal. Instead, cash values are a byproduct of the level premium method of paying for life insurance. Level premium policies represent a means by which individuals may spread the total cost of their life insurance evenly over the duration of their policies — which could be over their entire lifetime. Whole life insurance is a product that makes it feasible for older persons to continue their life insurance protection at an affordable, known-in-advance cost. Term insurance gets prohibitively expensive at the older ages.

2. Taxing the inside buildup would penalize older Americans because the tax increases dramatically with age. The Administration's proposal would destroy the level cost feature because the tax would increase each year as the insured becomes older. This is wrong. It would constitute the first "age indexed" tax in the history of our nation.

3. Taxing the inside buildup would be contrary to fundamental concepts of tax law. Since policyowners cannot receive these cash values freely except by surrendering their policy, they should not be taxed on them. To do so would be the same as taxing as income the appreciation in the value of a home, even though the owner has not sold it. This tax would completely reverse tax concepts that have been upheld by the nation's courts for the past 70 years.

4. Congress overhauled life insurance tax laws only last year, and in doing so, set strict standards to assure that only those contracts that provide legitimate insurance protection qualify under existing rules. Congress was concerned about contracts sold as life insurance contracts which sheltered enormous amounts of investment income. TEFRA limited the extent to which investment income could be sheltered

on contracts with variable premiums by defining which of these policies qualified as life insurance. In the process, some policies were excluded from life insurance treatment. DEFRA placed further limitations on the contracts that could qualify as life insurance. If Congress believes it is still possible for contracts that meet the definition of life insurance to provide excessive shelter of investment income, it would be better to further limit the contracts which qualify as life insurance rather than tax the inside buildup of all newly purchased contracts.

5. Level premium life insurance is not a tax loophole for the rich. Taxing the inside buildup would hit modest and middle income individuals the hardest since most owners of permanent life insurance are in this category. In 1983, for example, two-thirds of all cash value insurance policies were purchased by persons with incomes below $25,000. Ninety percent of the policies were purchased by those whose incomes were less than $45,000. And only 5 percent of purchases had income over $100,000. A 1984 study indicates that only 12 percent of policyowners choose life insurance for tax reasons.

6. Taxing the inside buildup conflicts with the goal of tax simplification. Complex calculations and reporting would be needed for millions of policyowners. It's naive for the Administration to assume that policyowners would be able to make those calculations on their own. So, millions of Americans would have to seek expert assistance to help them figure out what their tax liabilities will be from this proposal. This, of course, would increase the fees they pay to tax preparers. Alternatively -- and more likely -- the insurance industry would be forced to compute and report these taxable amounts. In this case, the expense to insurers would be substantial. And so would be the government expense in monitoring compliance.

   Further complications can arise just by reason of the type of policy involved. The Administration's proposal shows a lack of understanding of the complications that can occur. For example, some policies, such as level premium term insurance of longer durations, develop cash values which initially increase each year, then decrease to zero by the end of the term period. Operation of the Administration's tax proposal would produce positive imputed income during some years followed by negative imputed income in others. A far cry from simplification!

   Other policies — Adjustable Life, for example — have built-in flexibility which allow insureds to increase or decrease their insurance protection and/or premiums to accommodate their then current needs. The Administration's proposal calls for taxing the increase of such a policy under the new rules, while continuing to tax part of the policy under the old rules. To call this a policy of "tax simplification" is also dishonest!

7. The proposals would discourage the purchase and maintenance of level premium life insurance. As a result, the financial security provided by life insurance would be impeded and the social value of such protection would be impaired. A reduction in the amount of insurance purchased by individuals would lead to additional pressures on the government to provide increased economic security. The government's resources are already strained to meet its existing commitments. Government policies should continue to encourage individual arrangements for the financial protection of one's dependents, instead of discouraging such self-reliance through proposals to tax individual life insurance.

   It is clear that the American people oppose the taxation of life insurance. In a 1985 national survey by Yankelovich, Skelley & White, 83 percent of the respondents said that a tax on permanent life insurance would make the product less desirable. In other words, taxation would discourage Americans from using life insurance for guaranteed financial protection for their families in the event of the death of the breadwinner.

8. Reduction in the purchase of permanent forms of life insurance would curtail life insurance company funds available for long term investment and capital formation. Life insurance companies are a major source of long term investment capital. In 1983, for example, acquisitions of long term investments by U.S. life insurance companies totalled $170 billion, of which $57 billion was traceable to new funds. In 1983, life insurance companies ranked third among private domestic institutional sources of funds for the capital markets. A substantial portion of the cash flow available for new investments by life insurance companies comes from premiums on cash value life insurance. Term insurance premiums available for investment are negligible. The Administration's proposal would diminish the demand for cash value life insurance. In turn, this would diminish the role of life insurers in the long term capital markets -- adversely affecting capital formation and our overall economy.

9. The tax proposal would not raise significant additional federal revenue for many years — and perhaps never. Consumers will be discouraged from purchasing new cash value life insurance. The additional tax revenue expected from them is contingent on there being a base of increasing cash values to which the tax rates are applied. That base will be small, and perhaps non-existent.

10. The Administration's argument that this proposal makes for a level playing field among the life insurance industry and its competitors is specious. Banks have access to funds at the Federal Reserve discount window at attractive rates. They and other financial institutions have access to checking accounts or passbook savings accounts at very low rates of interest. The FDIC guarantees deposits for individuals up to $100,000 in return for modest and possibly inadequate premiums baid by the financial institution. And in cases of massive failures

such as Continental Illinois, the government steps in and bails out the institution. By contrast, in instances where a life insurance company has become bankrupt or insolvent, guaranty associations set up by the insurance industry have stepped in to make good on the promises made to that company's policyowners. The federal government is not involved. Finally, the discussions about "level playing fields" make no mention of the premium taxes which life insurance companies pay to state and local governments. Typically, these taxes amount to two percent of all life insurance premiums collected. Other financial institutions competing for the same dollars do not pay this tax.

In summary, the proposal to tax policyowners on their life insurance conflicts with major goals of rational tax policy -- namely greater capital formation and tax simplification. To the contrary, adoption of the proposal would retard capital formation and would complicate the administration of the individual income tax for policyowners, insurance companies and the government. While producing little or no immediate additional revenue, the proposal would disrupt the purchase of permanent life insurance and would seriously damage an important industry. Any tax payable would be borne largely by those modest and middle income taxpayers who are the major purchasers of life insurance. This would discourage them from taking care of their own financial needs through the purchase of insurance, thus creating new needs for welfare and placing additional strain on government financed programs. It does not create a level playing field among life insurance companies and competing financial institutions. The proposal makes no sense -- either on economic, legal, or social grounds. It should be rejected.

In addition to the proposal to tax policyowners on their cash values, the Administration's plan also includes proposals to change the basis of taxation of life insurance companies themselves. The proposal to limit a company's reserve deduction to cash values shows an incomplete understanding of the industry and its obligations to its policyowners. Reserves are required for the industry's obligations under many policies which do not provide for cash values. Examples would be reserves for disability income policies and many term insurance policies. Specific reserve standards are established by the various States, working through the National Association of Insurance Commissioners. If a life insurance company's reserves were to be limited to cash values, most companies would literally be insolvent. No competent actuary would certify that such a company had made adequate provision for its obligations to its policyowners. And finally, to reemphasize a point made earlier, Congress overhauled and "reformed" the insurance industry tax laws only last year. And while there are some important inequities which remain in life insurance company taxation, they are not being addressed by the Administration's current tinkering with the reserve deduction. As Richard Schweiker, president of the American Council of Life Insurance, said recently, "Life insurance company taxation was reformed last year. How many times do you have to be reformed in this town?".

Minnesota Association of REALTORS®
Comments to Senator Dave Durenburger
on the Reagan Tax Plan

The Minnesota Association of REALTORS® would like to commend the President for initiating a national debate on tax policy. The President's goals of fairness, simplicity, and lower tax rates embody basic principles for which our country stands.

The one element which we find blatantly lacking in this tax plan, however, is that of deficit reduction. Not only does the Reagan tax plan fail to address this issue, but projections by the Treasury Department and DYNAMIC analysis indicate that the proposal could actually increase the annual deficit anywhere from $12 billion to $50 billion in the next several years. This is totally unacceptable to our organization. The federal deficit and the resulting high interest rates have already damaged the economy through reduced investment in plants, equipment and housing, and a declining ability of U.S. industries to compete in world markets. Neglecting to deal with this issue in the midst of a substantial tax reform is a mistake. The longer we delay in cutting the federal deficit, the more painful the necessary spending cuts and tax increases will become. The Minnesota Association of REALTORS® believes very strongly that any tax reform proposal must include measures to reduce the federal deficit.

There are several provisions of the Reagan proposal which are particularly significant to both homeowners and Minnesotans, and we feel should be addressed. The first is the elimination of state and local tax deductibility. If those deductions are lost, it is felt that many companies will accomodate their employees by moving to lower-tax states. Minnesota's existing problem in competing for business would be greatly exacerbated. This would have an effect on industry, commerce and the rental and housing markets. Eliminating this deduction could also put pressure on the state to do away with valuable programs such as school aid and homestead credits. The implications for our state are far-reaching and the Minnesota Association of REALTORS® would be unable to support such a measure.

In addition to disadvantages for our state, the homeowner would appear to benefit less than other groups under the Reagan tax proposal, since it is the homeowner who generally itemizes his/her deductions. The elimination or reduction of some of these deductions would affect the homeowner greatly, even though offset by a lower tax rate. It has historically been an important part of American public policy to give special incentives to homeownership. The theory is that we preserve our shelter better if we own it, and we'd have a more efficient mode of providing shelter for Americans. We don't feel the public is prepared to reverse this policy. For renters, the tax benefits of the Reagan plan appear much greater. Yet, incentives to invest in real estate would be considerably lessened and owners of rental property would be under great pressure to raise rents. The renter will be advantaged only until the rent goes up.

The Reagan administration's attempts to diminish several tax benefits for corporations, to encourage corporate decision makers make investments in plant and equipment more for the purpose of generating profits and less for the purpose of avoiding taxes, are laudable. Many of the Presidents provisions also take steps in the direction of tax simplification and increased accountability, measures consistently encourgaged by the Minnesota Association of REALTORS®. While it is not yet certain what result these changes would cause in investment and growth, we support the President's overall goals in this area.

Many politicians and special interest groups find themselves in a difficult position over the Reagan proposal. They like the whole but dislike many of the parts. The Minnnesota Association of REALTORS®, however, would be willing to accept the majority of its parts, including the limit placed on mortgage interest deductibility for second homes and the discontinuance of mortgage revenue bonds, if the overall direction of the proposal shifted towards the more crucial area of deficit reduction. Tax reform is desirable, but it is the federal deficit that is threatening our very future. Until this problem is addressed we can accept only parts of the Reagan proposal, but not the whole.

TESTIMONY ON

CAPPING DEDUCTIBILITY OF BUSINESS MEALS

BEFORE THE

SENATE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS

SENATOR DAVID DURENBERGER, CHAIRMAN

Prepared By

TOM NEWCOME

LEGISLATIVE LIAISON

for the

MINNESOTA RESTAURANT, HOTEL AND RESORT ASSOCIATIONS

JULY 2, 1985

Mr. Chairman, my name is Tom Newcome. I am Legislative Liaison for the Minnesota Restaurant, Hotel & Resort Associations. Thank you for the opportunity to present the views of the hospitality industry. We represent nearly 1500 restaurants, hotels, motels and resorts throughout the state. A large percentage of our members are small independent business people operating a single family owned business.

We stand ready to assist you as you consider tax reform proposals to allow for simplification, economic growth and fairness for all Americans.

As you are already very much aware, the Administration has been deliberating over the next tax bill. Unfortunately for the hospitality industry, the Administration wants to limit severely the otherwise legitimate deductions for business entertainment and travel. It doesn't realize that business spending often makes the difference between profit and bankruptcy in our industry.

All segments of Minnesota's hospitality industry are alarmed by these severe proposals and have joined with the National Restaurant Association and the American Hotel and Motel Association to oppose the Adminstration's stance on business meal deductions. That recommendation from the Adminstration would limit the deduction for business meals to $25 per person per meal and 50 percent of anything over $25.

Business people all over this country entertain potential customers or clients at meals in order to develop business. As Senator Russell Long once said, "The business meal is to business what fertilizer is to the farmer. It increases the yield." The cost of these meals is a legitimate business expense. As long as the law continues to recognize the deductibility of business expense, there is no logical rationale for capping, limiting, or reducing the business meal deduction.

Foodservice employees and employers all over Minnesota adamantly oppose the proposal to cap the business meal deduction for three reasons:

1) It would devastate Minnesota's restaurant and lodging industries causing thousands of jobs to be put at risk. Our hospitality industries are labor intensive: a small decline in the number of operating businesses will put a disproportionately large number of people out of work. Moreover, the workforce in hospitality industries tends to be either very specially skilled or not skilled at all. In both cases, workers are not readily employable in other industries.

2) It would endanger one of Minnesota's leading sources of new jobs. During the past two decades hospitality industries have been a primary source of entry level jobs for this state's young and unskilled workers. It has been those jobs that often have served as the employment foundation.

3) The disruption of the foodservice industry would in turn lead to a considerable loss of revenue to local, state and federal governments. Curtailling business entertainment deductions will not squeeze more taxes from business. Business meals and entertainment are subtle, and very legitimate forms of advertising. For the small businessman, they

are the primary methods for contact and discussion opportunities with clients. Since the need for a business to promote its services still remains, businesses will shift to more conventional and often more expensive advertising.

In addition, limitations on business meal expenditures would severely and irreparably impinge on the foodservice industry to the detriment of the national economy as a whole. Specifically, the results in 1986 would be:

- the loss of 140,000 foodservice related jobs and a rise in the national unemployment rate of one-tenth of one percent;
- a decrease in state and local revenues from personal income taxes and sales ; and
- a decrease in federal revenues from personal income taxes and Social Security taxes and an increase in federal expenditures for unemployment compensation and welfare payments.

These effects are detailed in a study conducted for the National Restaurant Association by Chase Econometrics, a respected, credible economic consulting and research organization.

The hospitality industry in Minnesota employs more that 110,000 full-time persons and thousands more part-time and pays its fair share of taxes. If business entertainment drops because of this proposal, they will have no alternative but to lay off some trusted workers and cut back on the purchase of local furnished supplies. At a time when the Administration has made such progress in lowering the nation's unemployment rate, the Adminsitration proposes to jeopardize one of our nation's most labor-intensive industries. This makes no sense.

Many people from many sectors of the economy will suffer if you endorse the Administration's harsh cut backs on business meals and travel-related deductions. On behalf of our Associations' members, throughout the state, their employees and their suppliers, we ask your support for this legitimate, proper business activity.

Thank you for your consideration of our position.

○